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Fall 1986

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Second-class postage paid at Washington, D.C.
USPS I.D. No. 14209; Publication No. 551640;
ISSN 0745-1253
Subscription rates:
one year, \$15 (\$20 foreign);
two years, \$27 (\$37 foreign).
Send address changes to:
The Brookings Review
1775 Massachusetts Avenue, N.W.
Washington, D.C. 20036
U.S. newsstand distribution by Four Star News
Distributors, Inc., 33-30 57th Street, Woodside,
New York 11377.

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Taking the Dangers Out of Bank Deregulation

Robert E. Litan

FOR BANKS, these are turbulent times. In each of the past four years, the number of bank failures has risen — last year, to a postdepression record of 120. Bank profit margins continue to shrink as the securities, insurance, manufacturing, and retailing industries invade the deposit-taking and lending activities that banks once monopolized. As a result, the banking industry is playing a steadily less significant role in financial intermediation in the United States. In 1946 commercial banks had 57 percent of all assets held by American financial institutions. By 1985 the bank share had fallen to just 33 percent (see figure 1).

Not surprisingly, the banking industry has been urging Congress during the past five years to lift restrictions on the kinds of financial products banks can offer — or, as the industry puts it, to provide a “level playing field.” In 1983 the Reagan administration agreed and formally proposed to Congress that banks be permitted through their holding companies to enter any financially related business except for underwriting corporate securities. The Senate passed a stripped-down version of the administration proposal in late 1984, but the House took no action. This stalemate, which has continued through the 1986 legislative session, reflects the opposing positions of Senate Banking Committee Chairman Jake Garn, R-Utah, who advocates wider powers for bank holding companies, and House Banking Committee Chairman Fernand J. St Germain, D-R.I., who favors continued restrictions on bank activities.

This article suggests that, congressional inaction notwithstanding, market forces will continue to drive an increasing number of banking organizations to expand into nonbanking enterprises. Some organizations will take advantage of loopholes in existing federal laws. Other banks, those chartered by the states rather than the federal government, will gradually be allowed by state legislatures to diversify their product offerings.

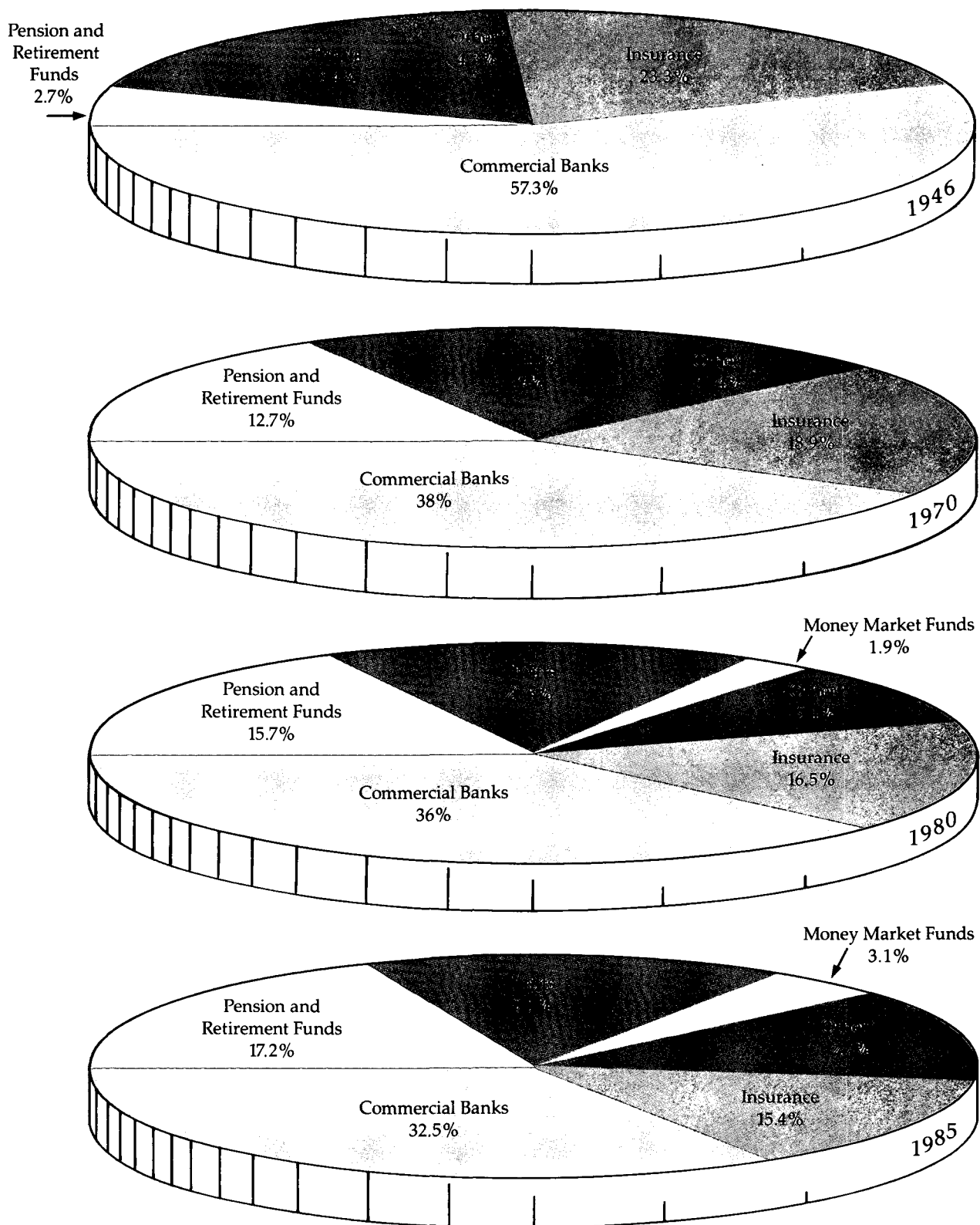
The critical challenge facing Congress, therefore, is not so much whether to relax the constraints on banking organizations, but to determine the pace at which the barriers separating banks and other financial institutions will be removed and the conditions, if any, that should be placed on bank participation in nonbank businesses. The concluding section of the article outlines a novel, and admittedly controversial, approach that, in this author's view, would permit quick removal of restrictions on bank activities without creating the dangers that opponents of expanded bank powers fear.

Why Banks Are Regulated

Banks have long attracted the special attention of policy-makers. When nonbank enterprises fail, the ripple effects on other companies and on individuals are

*Robert E. Litan is a senior fellow in the Economic Studies program at Brookings and of counsel to Powell, Goldstein, Frazer & Murphy. He is the author of the forthcoming *What Should Banks Do?* and co-author of *Reforming Federal Regulation and Saving Free Trade: A Pragmatic Approach*.*

Figure 1. Percentage Distribution of Assets of Financial Institutions, Selected Years



*Includes finance companies, credit unions, security brokers and dealers, investment companies, and beginning in 1970, real estate investment trusts (REITs).

Source: Alan S. McCall and Victor L. Soulbury, "The Changing Role of Banks and Other Private Financial Institutions," *Regulatory Review*, April 1986, p. 6.

generally confined to narrow regions of the country or sectors of the economy. However, when banks go under, the consequences can be far more dramatic. The continued operation of the banking system, as well as the wider economy with which it is inextricably linked, rests entirely on the confidence of depositors in the safety of the institutions holding their funds. A bank failure, particularly one involving a large institution, can threaten that confidence, triggering deposit withdrawals, or "runs," on healthy banks. If banks fall in domino fashion, the money supply can implode, as it did between 1930 and 1933 when over 9,000 banks closed their doors.

Federal deposit insurance, introduced in 1933 for bank deposits and in 1934 for savings accounts, has largely eliminated this danger by removing the incentives for most depositors to withdraw funds even when their banks are rumored to be in trouble. To be sure, some depositors remain at risk: the current ceiling on deposit insurance coverage is \$100,000 per account (up from the original \$2,500 ceiling). However, as a practical matter, even large depositors have been fully protected because the insurance agencies have found it less expensive to arrange for the merger of troubled depositories with healthier organizations than to force the failing institutions to close.

The virtues of federal insurance were vividly demonstrated in 1985, when the collapse of certain savings and loan associations in Ohio and Maryland insured only by private (Ohio) or state (Maryland) insurance funds triggered runs on all other thrifts in each state insured by the same funds. Significantly, the *federally* insured depositories in these states remained untouched by the panic.

Despite its success, deposit insurance has not removed the need for regulating the conduct of banks or thrifts. To the contrary, precisely because the Federal Deposit Insurance Corporation (FDIC), which insures banks, and the Federal Savings and Loan Insurance Corporation (FSLIC), which insures thrifts, now effectively insure more than \$2 trillion in deposits, the federal government has a legitimate interest in seeing that the insured institutions are operated soundly.

Historically, federal banking regulators, together with their counterparts at the state level, have discharged this responsibility by periodically examining banks. Where these examinations uncover banking practices that are unduly risky, the regulators typically "suggest" changes; in extreme cases the regulators will bring formal enforcement actions to remove bank officers and directors. The effectiveness of bank supervision is inherently limited, however. Examinations are costly and time-consuming; and the most important aspect of a bank's balance sheet, the quality of its loan portfolio, is difficult to assess at any given time.

Perhaps in recognition of these limitations, federal regulators are increasing "capital" requirements. These provisions are designed to ensure both that shareholders have

a sizable stake in the performance of their banks and that the institutions themselves have a financial cushion to absorb significant losses. All banks now must fund at least 6 percent of their assets with equity contributions from shareholders and accumulated retained earnings from prior years. In August the Federal Home Loan Bank Board decided to gradually raise the minimum capital requirement for thrifts, long held at only 3 percent of assets, to 6 percent.

Insulating Banks

Yet supervision and regulation have not overcome a deep suspicion of banks that has existed since the nation was founded and that has motivated repeated attempts to wall them off from other types of enterprises. In earlier periods these barriers were eroded by market forces, only to be resurrected in different forms.

The separation of "banking" from "commerce" had its origin in restrictions that Parliament placed on the Bank of

*"Yet supervision and regulation have
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England in response to pressure from English merchants who feared the bank's competition. The charters of the first two federal banks of the United States prohibited them from trading in goods or owning more real estate than they needed for their banking operations. In 1864 the National Bank Act allowed banks with a national charter only to accept deposits, extend loans, and engage in activities "incidental" thereto.

Federal barriers against bank participation in other enterprises, however, did not prevent private banks and banks chartered by the states from ranging far more widely. As early as the 1830s these banks (as well as the Second Bank of the United States itself) were active in purchasing and then reselling — or "underwriting" — federal and state government securities. At the turn of the twentieth century certain states allowed their banks to market insurance. And by the 1920s both state banks and state-chartered affiliates of national banks competed with private investment banks to underwrite both corporate and government securities. Indeed, by 1930 — on the eve of the Great Depression — banks were underwriting almost half of all new securities issued in the United States.

The depression brought bank financial product diversification to a grinding halt. Although there was no evi-

dence that the securities underwriting practices were a significant cause of the collapse of the banking system, or that certain highly publicized abusive underwriting practices were widespread throughout the banking industry, Congress divorced commercial from investment banking in the Glass-Steagall Act of 1933. That law did not, however, prevent bank holding companies from using corporate subsidiaries to engage in nonbanking businesses. Congress attempted to close off that opportunity by enacting the Bank Holding Company Act of 1956, which effectively barred holding companies that owned more than one bank from also owning other types of enterprises. Congress took this step not so much because it believed that product diversification threatened the safety of the banking system, but primarily because it feared that large bank holding companies might otherwise amass too much economic power.

The 1956 law did not stop banking organizations from diversifying, however. In the 1960s an increasing number of them began to take advantage of the fact that the restrictions did not apply to "unitary" bank holding companies, those that owned a *single* bank. By 1970 over 700 unitary banking organizations had expanded not only into other financial activities such as insurance, securities, and real estate but into manufacturing and retailing as well. Congress plugged the loophole in 1970, forcing those holding companies that had diversified to divest themselves of all enterprises not engaged in activities "closely related to banking." Congress had placed similar restrictions on the outside activities of multithrift holding companies in 1967. Although the Federal Reserve has since announced that roughly 20 activities — such as trust accounts management, mortgage banking, property leasing, and data processing for bank-related enterprises — are "closely related to banking," bank holding companies are effectively prevented from entering most other financial activities as well as all commercial and manufacturing endeavors. Until recently the Bank Holding Company Act also had the effect of preventing nonbank organizations from owning or competing with banks.

Competitive Assault on Banks

Events of the last decade, however, have altered the playing field on which banking organizations compete. As shown in table 1, banks now face stiff competition in offering the services represented by each of the major accounts in their balance sheets. Significantly, in each case alternative suppliers have been able to compete effectively even though they do not have the benefit of deposit insurance, which allows banks to gather funds and lend them out at lower interest rates than other lenders charge.

Consider first the services that appear on the asset side of the typical bank's balance sheet. Federal Reserve data show that nonbank companies supply more credit to consumers than banks do. In 1985 finance companies, credit unions, retailers, and savings institutions held 56 percent of all consumer debt; banks held 44 percent, down from 48 percent in 1980.

More significant, banks are severely threatened in commercial lending, which they have traditionally dominated. In the 1950s, for example, American banks extended over 85 percent of all short- and intermediate-term credit to U.S. corporations. By the 1980s the banks' share had fallen to little more than 60 percent, due in large part to the rising importance of commercial paper. The declining competitiveness of banks in the commercial lending field is particularly evident at the nine largest money center institutions. In 1975 these banks extended 25 percent of all short- and intermediate-term commercial credit in the United States. By 1985 the share held by those money centers had fallen to just 15 percent.

Banks are also being challenged in their deposit-taking activities. Thrift institutions offer the equivalent of demand deposits, or Negotiable Order of Withdrawal (NOW) accounts. Moreover, deposits held in money market funds (\$241 billion in December 1985), certain of which permit unlimited check-writing, rival total demand deposits at banks (\$281 billion).

Perhaps more noteworthy than each of these compari-

Table 1. Alternative Suppliers of "Banking" Services
(Classified by Major Accounts on a Typical Bank's Balance Sheet)

	Insurance Companies	Securities/ Investment Companies	Pension Plans	Thrifts	Other
Asset Side					
Commercial Loans				\$	Commercial paper market; industrial finance companies
Commercial Mortgages	\$		\$	\$	
Consumer Loans (excluding auto loans)				\$	Retailers; consumer finance companies; credit card companies
Auto Loans				\$	Auto companies
Consumer Mortgages	\$	\$		\$	Mortgage bankers
Liability Side					
Transaction Accounts		\$		\$	
Long-term Deposits	\$	\$		\$	

sons, however, is the fact that companies outside the banking industry are increasingly diversifying into a broad range of financial activities, attempting to become modern financial supermarkets. Some of these financial conglomerates — such as American Express, Merrill Lynch, and Prudential-Bache — are household names, providing a wide range of depository, lending, and investment services. Less well known, but in the longer run more significant, are the nonfinancial giants that have entered the field. The finance subsidiaries of each of the American automobile companies — Chrysler, Ford, and General Motors — not only lend to purchasers of automobiles but are also highly active in mortgage banking. General Electric's finance subsidiary, GE Credit, is among the nation's leading business lenders and, with the recent acquisition of Kidder Peabody, is now a major investment banker. And there is Sears, the nation's largest retailer, which also has subsidiaries offering insurance, real estate, and securities services.

Even more worrisome to the banks, Sears and numerous other conglomerates have exploited two gaps in existing law and now offer banking services through federally insured banks or their near equivalents. The first gap is in the law governing the outside activities of thrift organizations, which unlike the bank holding company law, does not cover unitary thrift holding companies. Nonfinancial enterprises such as Parker Pen, J.C. Penney, and National Steel have taken advantage of this exception to purchase thrift institutions, which in recent years have been allowed to offer consumer and commercial loans and transaction accounts in direct competition with banks.

The second gap is in the Bank Holding Company Act itself. As its name suggests, its activity restrictions apply only to "bank" holding companies. But the law defines a "bank" as an institution that *both* accepts demand deposits and extends commercial loans. In 1980 Gulf & Western became the first of many nonbanking companies (including most large securities houses and certain large insurers) to escape regulation as a bank holding company by operating an insured depository offering only consumer loans. In the Alice-in-Wonderland world of banking law, such institutions are called "nonbank" banks.

Not to be outdone, over 50 bank holding companies have also attempted to exploit the "nonbank" bank loophole by applying for charters to open limited-purpose banks in other states, thus circumventing the law's restrictions against interstate banking. The courts, however, will determine the success of this ploy. The Supreme Court expressly ruled in 1985 that nonbank banks do not fall within the definition of a "bank" and therefore are not subject to the restrictions against interstate banking. But a Florida district court has enjoined the comptroller of the currency from issuing national bank charters for institutions that do not both accept deposits and lend to commercial customers.

Why have banks been assaulted from so many directions? One reason is inflation, which in the late 1970s pushed interest rates on government securities far above the interest rates that banks and thrifts were then limited by law to paying their depositors. Seemingly overnight, the money market fund industry exploded, drawing billions of dollars away from bank deposits. NOW accounts offered by thrifts in certain northeastern states had the same effect. Although Congress subsequently removed the interest rate ceilings on bank deposits, both thrift institutions and money market funds (and the securities companies that have sponsored the funds) have continued to be strong competitors to banks in providing transaction services.

Interest rate deregulation has also facilitated nonbank competition in lending activities. In a deregulated climate, banks have had to pay more for their funds than they used to and thus have had to increase the interest rates they charge on their loans. This situation has narrowed their competitive advantage over lenders who must rely on un-

*"... companies outside the banking
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insured debt and equity to fund their activities but who also do not incur the costs of reserve requirements, deposit insurance premiums, and regulatory compliance that banks must bear.

The booming securities market of the 1980s has also encouraged public corporations to raise funds directly through the capital markets rather than by borrowing from banks. In 1979 new securities (excluding commercial paper) offered by corporations totaled \$52 billion and represented just 18 percent of the \$291 billion in commercial loans held by banks at the end of the year. But by 1985 the volume of corporate securities issued (\$156 billion) had soared to 31 percent of all end-of-year bank commercial loans (\$496 billion).

Finally, several forces have stimulated the rise of the diversified financial conglomerates, which thrive on their ability to offer a wide range of financial services and in particular to cross-sell those services to the customers of each of their subsidiaries. Sears, for example, aggressively markets its securities and real estate brokerage services to its credit card holders. With its new "Discover" card, Sears is attempting also to market its banking services (through its Delaware-chartered nonbank bank) to its retail customers. A ready market awaits those diversified financial

institutions that do cross-sell. A 1984 study published by the Federal Reserve Bank of Atlanta reported that 50 percent of the customers surveyed said that it would be "somewhat" or "very" desirable to be able to obtain all their financial services through a single company. Of those, 93 percent said they would like that single company to be a depository institution. Many customers prefer to deal with specialized providers. But in a country with an increasing proportion of two-earner families, the convenience of being able to bank, obtain insurance, secure a mortgage, purchase a home through an agent, and make investments at the same place explains why there is a potentially large market for diversified financial institutions.

There are other reasons for financial institutions to diversify. Just as individuals purchase mutual funds to spread the risks of their stock and bond holdings, banking organizations can benefit by offering services that help smooth out the earnings fluctuations of bank activities alone. Based on profit data reported to the Internal Revenue Service, I have calculated that over the 1965-82 period, the average bank organization could have achieved the same level of average earnings as it did, but with 45 percent less fluctuation (or variance), had bank holding companies been permitted to diversify into currently proscribed financial activities. These potential gains from portfolio diversification are important because, if realized, they would benefit both banks and the agency that insures them, the FDIC.

Financial institutions that diversify should be able to offer multiple services more cheaply than the aggregate costs of providing them through separate organizations. An institution that advertises bank services, for example, can also market securities, insurance, and real estate services at little or no extra cost. There are also potential "economies of scope" to be realized in the combination of "back-room" operations. As former Citicorp Chairman Walter Wriston has observed, banks, insurance companies, and other financial service companies are all essentially in the same business — providing and transferring information.

A bank is essentially a computer data base that stores information about deposits and loans. An insurance company stores information about what to pay to whom in the event of certain accidents or catastrophes. Securities and real estate brokers match buyers and sellers through computer-stored data bases. Any financial corporation doing business today should be capable of using the computer-stored data that lie at the core of one financial service to deliver other services and thus lower the costs of providing them all.

Attempts by Banks to Fight Back

Banks cannot afford to sit idly by as increasing competition and rising loan losses cut into their profit margins. In 1979 the banking industry earned 14.3 percent on its capital. By 1984 the industry's rate of return had fallen to 10.7 percent.

In the absence of new federal legislation, however, banks can expand their activities in only two ways. First, a banking organization already heavily involved in real estate lending may find it desirable to convert to a unitary thrift holding company by switching its bank charter for a thrift charter. As just noted, current law does not restrict the activities of such institutions. Recent events, however, have made this option less attractive. To supplement its dwindling reserves, which have been depleted by the rising costs of closing insolvent thrifts, the FSLIC has increased the premium insured thrifts must pay. As a result, the agency that regulates the thrift industry, the Federal Home Loan Bank Board, is concerned that many thrifts will convert to banks in order to qualify for the lower deposit insurance premium charged by the FDIC.

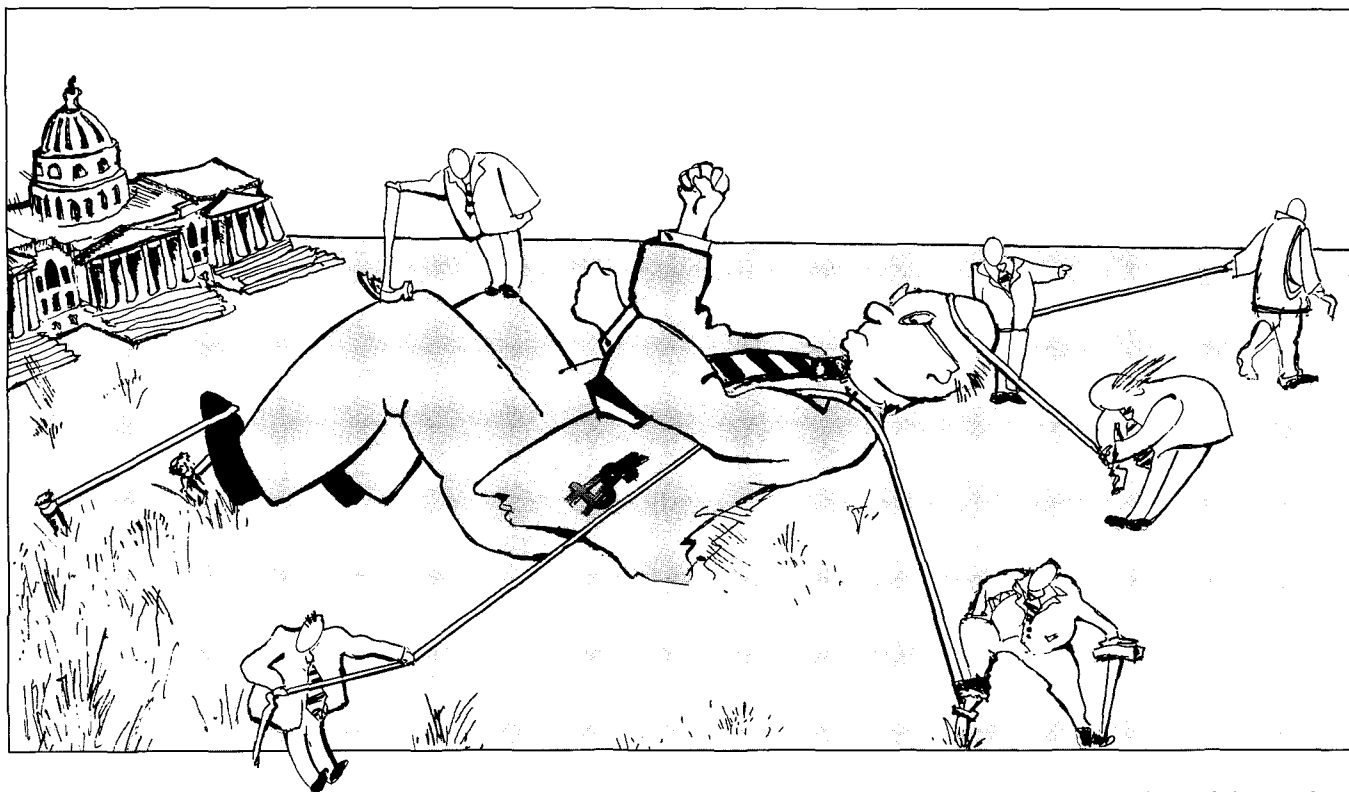
Second, state-chartered banks — which account for roughly 70 percent of all banks but only 45 percent of all bank deposits — can expect to expand their services as state legislatures liberalize their bank activity laws. Certain states — such as Iowa, Nebraska, and North Carolina — have long allowed their state-chartered banks to sell insurance. Other states have begun to widen the activity

Table 2. Authorized Activities of State-Chartered Banks in Selected States*

	Ala.	Alaska	Calif.	Fla.	Iowa	N.Y.	N.C.	Ohio	S.D.
Insurance									
Underwriting	\$	\$					\$		\$
Brokerage	\$	\$			\$		\$		\$
Securities									
Underwriting	\$	\$	\$			\$	\$	\$	
Brokerage	\$		\$				\$		
Real Estate									
Development	\$	\$	\$	\$		\$	\$	\$	
Brokerage	\$	\$	\$	\$	\$	\$	\$		\$
Travel Agency	\$	\$	\$		\$	\$	\$	\$	\$
Management Consulting	\$	\$	\$		\$		\$	\$	

*This list is not exhaustive.

Source: Conference of State Bank Supervisors, as of August 1985.



authorities of their banks, allowing them to engage not only in insurance, securities, and real estate, but in travel service and management consulting as well (see table 2).

Given the movement toward financial product diversification, it is inevitable that the states will continue to expand the range of businesses that they permit their banks to enter, just as most states have repealed their interest rate ceilings on consumer credit and begun to remove the barriers that have long prevented entry by out-of-state banking organizations. The states will discover, as South Dakota has, that broader bank activity authority can be useful in increasing the tax base and statewide employment. As the states expand the powers of the banks they charter, national banks throughout the country will have increasing incentives to convert to state banks.

Such a movement, or the threat that one could begin, may eventually force Congress to level the playing field for national banks or bank holding companies by expanding their powers. There is a historical precedent for this sequence of events. Faced with an increasing number of state-chartered banks in the 1920s that were permitted (and also chose) to underwrite corporate securities, Congress granted similar authority to national banks in the McFadden Act of 1927.

The problem for the banking industry, however, is that it will take time — perhaps several decades — for this process of liberalization to play itself out. In the meantime, the competitive assault by nonbanks on banks will continue, unless Congress ends its stalemate and deregulates bank activities.

The prospects for any immediate action are remote. This past summer, Congress failed yet again to agree on even a modest expansion of bank powers when Senator Garn pared down his omnibus banking reform proposal to deal only with failing depository institutions. The senator's decision disappointed proponents of financial prod-

uct deregulation but pleased many federal lawmakers who have deep-seated reservations about further blurring the lines that separate nonbanking and banking institutions.

Most important, given the recent financial difficulties experienced by many banks and the large lending commitments made by certain money center banks to heavily indebted African and Latin American nations, there is widespread concern that activity deregulation could compromise the safety of the banking system. My results showing the potential benefits from portfolio diversification by bank holding companies suggest that these fears are unfounded for the banking industry as a whole. However, the fact remains that certain banking organizations might diversify in ways that increase their overall exposure to risk. I have found that between 1978 and 1984 over a third (11 of 30) of the largest bank holding companies had more volatile earnings patterns than their subsidiary banks, a result indicating that many banking organizations have already increased their risks through their limited nonbanking powers.

Second, many legislators fear that product deregulation would permit large bank holding companies and other financial conglomerates to accumulate too much economic and political power. Specifically, this concern relates to size of the resulting organizations: a merger of Chase Manhattan (with \$88 billion in assets in 1985), for example, with Phibro-Salomon (\$89 billion in 1985 assets) and Aetna Life & Casualty (\$58 billion in 1985 assets) would create a financial supergiant.

Finally, some opponents of deregulation claim that banks would use their financial product-line freedom to require borrowers to purchase other services offered by the banking organization, such as insurance, as a condition for obtaining a bank loan. This kind of requirement would harm both potential borrowers and the competitors

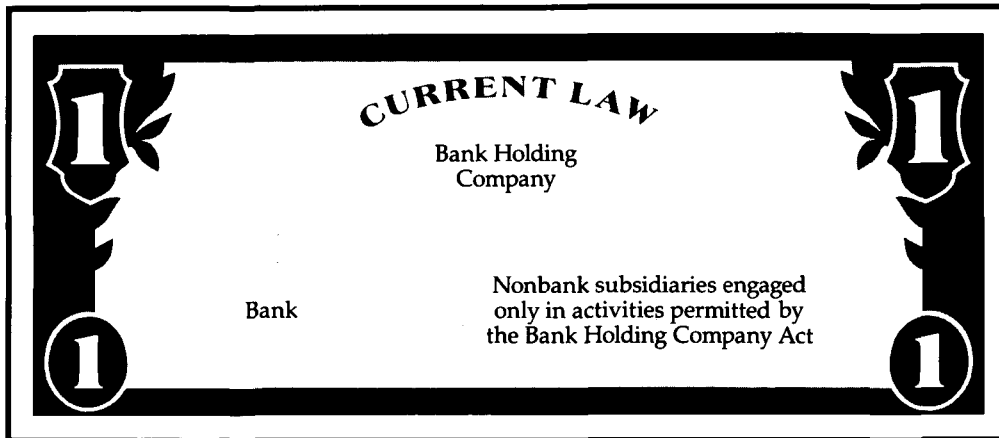
of the tied nonbank services. Others say that banking organizations could run into conflicts of interest by lending to less creditworthy customers of their nonbank affiliates — particularly those involved in securities underwriting and real estate brokerage — to generate fee income for those affiliates.

Try as they might, the banking industry and other independent analysts will find it difficult to allay each of these concerns, at least at the federal level, so long as the debate

nesota. It would meet each of the concerns that opponents of broader bank powers have raised. First, it would prevent a financial holding company from using the resources of its bank(s) to bail out “risky” nonbank affiliates. In the structure just outlined, deposit-taking subsidiaries would be limited to investing solely in high-quality, marketable instruments; they could not legally channel funds to support affiliated corporations or their customers.

Second, the fact that deposits could not be used to finance loans should remove most of the concerns about potential conflicts of interest. Third, the proposed structure should ease qualms that these financial organizations would hold excessive concentrations of economic power. These fears stem in large part from the fact that deposit insurance allows banks to gather large pools of funds and thereby to exercise significant control over the allocation of credit. If the banks in FHCs could not fund loans with insured deposits, there would be much less reason to be concerned about the size of the holding company.

Figure 2a. Structures of Diversified Banking Organizations Under Current Law



over expanded bank powers continues to be conducted as it has been thus far. Emotions on both sides of the issue run high. To resolve the question, lawmakers must choose between powerful financial interests — the banking industry on the one hand and the insurance, securities, and real estate industries on the other. No wonder that few lawmakers have been eager to enter the fray.

A Workable Solution

There is a way, however, to accelerate financial product-line deregulation that addresses each of these concerns. The answer lies in requiring diversified financial conglomerates, or financial holding companies (FHCs), offering banking services to separate their deposit-taking and lending activities. Specifically, the “bank” in an FHC would essentially be a money market fund, permitted to invest in highly liquid “safe” securities, such as obligations of the United States Treasury and high-quality commercial paper. Financial holding companies would extend loans through separately incorporated lending subsidiaries funded by uninsured debt and equity rather than insured deposits. FHCs that abided by these restrictions would be subject to the regulation of the Federal Reserve, but unlike bank holding companies that owned “conventional” banks, would be free to enter any activity, financial or otherwise (see figure 2). Meanwhile, diversified financial conglomerates that now own insured nonbank banks or savings and loans would be required to restructure to conform to this model, as would all nonbanking firms seeking to open or acquire insured depositories in the future.

This proposal has also been advanced in general terms by Hans Angermuller, vice-chairman of Citicorp, Carter Golembe and John Mingo, prominent Washington bank consultants, and John Karaken of the University of Min-

Practical Considerations

To be sure, numerous practical details would have to be worked out to permit implementation of this proposal. One obvious issue is whether the deposits collected by FHC-owned banks should be eligible for federal deposit insurance. Certainly, if these banks were permitted to invest only in short-term Treasury obligations (say, with maturities less than one year), there would be no need for insurance. Treasury securities carry no default risk. And interest rate risk, which can arise when the maturities of bank deposits are not perfectly matched with the maturities of bank investments, can be eliminated by permitting FHC-owned banks to invest only in short-term government obligations.

In all likelihood, however, the proposed separation requirements could not be implemented if the asset powers of these banks were so tightly restricted. The reason is that the total supply of privately held short-term Treasury securities is limited — roughly \$500 billion at the end of 1985. By comparison, the 35 leading banks in the United States collectively hold in excess of \$700 billion in loans. If all the parent companies of these banks suddenly elected to establish FHCs by transferring all loans currently held by their bank subsidiaries to newly formed lending subsidiaries, their depository affiliates would have to purchase up to \$700 billion in securities to replace those loans, an amount clearly in excess of the total short-term government instruments available.

Of course, it is unlikely that the depository subsidiaries of newly formed financial organizations would retain the same volume of deposits as they currently have. Some bank customers would be more than willing to exchange at least some portion of their insured bank deposits for the higher yielding, albeit uninsured, securities issued by the new lending affiliates. Nevertheless, the depositories would still

need to bid away vast sums of short-term Treasury securities currently held by other parties.

What other instruments could the depositories be safely permitted to hold? One candidate is commercial paper, which at the end of 1985 totaled \$301 billion (of which \$87 billion was issued by nonfinancial corporations). Of course, if potential conflicts of interest are to be eliminated, FHC depositories must be prohibited from purchasing commercial paper issued by customers of their lending affiliates. Another candidate is longer-term Treasury obligations; the outstanding volume of Treasury notes with one-to-five-year maturities now exceeds \$400 billion.

The case for extending federal insurance to FHC-owned depositories grows much stronger if the list of their permissible investments is expanded beyond short-term Treasuries. Commercial paper, even if it has a high credit rating, still carries a greater default risk than Treasury obligations. In addition, allowing these depositories to hold Treasury notes with longer maturities potentially introduces some interest rate risk. While less susceptible to failure than a conventional bank, even a depository with investments in commercial paper and longer-term Treasuries can fail and at least theoretically trigger the kind of widespread run that federal deposit insurance is designed to prevent. It would therefore be advisable to extend insurance to such institutions, but perhaps at lower premiums than are charged on deposits held at conventional banks.

A second issue concerns the coverage of the proposal. There is a good reason for imposing the suggested separation requirements only on the largest banking and thrift institutions, say those with deposits over \$500 million (such institutions currently hold roughly 65 percent of all bank and thrift deposits). Smaller institutions would have great difficulty implementing separation because of their limited abilities to sell their uninsured securities on the open market. An exemption for small institutions — which would allow them to diversify without divorcing lending from payments activities — would not be inconsistent with the spirit of the separation requirement since the concerns that separation addresses are aimed primarily, if not exclusively, at the largest banks.

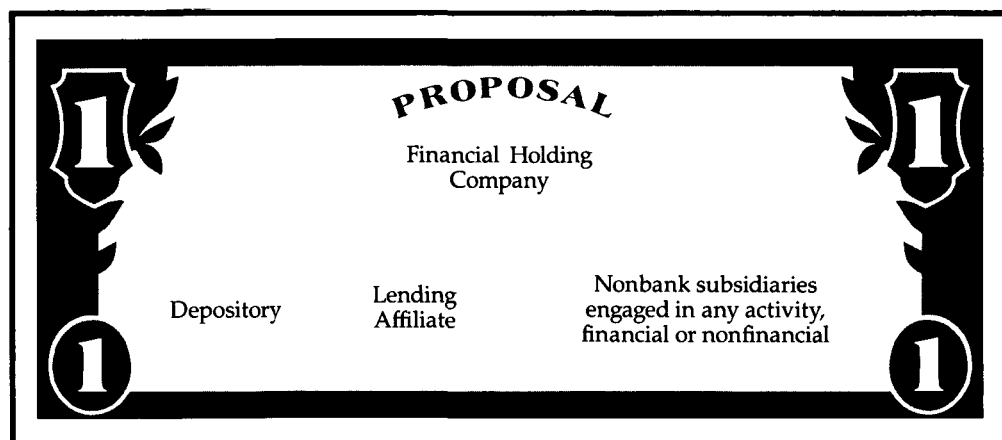
A third question relates to timing. The banking organizations most likely to be interested in forming FHCs — the largest banks — could find it extremely difficult to refinance quickly all of their loans with uninsured securities. Citibank alone has over \$100 billion in outstanding loans. If banking organizations could not expand their activities until their loan portfolios were *completely* transferred to separate affiliates, it is unlikely that many would undertake the restructuring. A sensible transition rule, therefore, would be to free existing bank holding companies from the activity restrictions so long as their subsidiary banks adhere to a schedule in transferring their loan portfolios to new lending affiliates. Thus, if the transition period were 10 years, a bank organization that has \$20 billion in loans

would have to transfer at least \$2 billion in loans out of its subsidiary bank(s) the first year, \$2 billion more the second year, and so on. If at any time, the banking organization fell behind the statutory schedule and failed to correct the situation within a short period (say, 60 days), it would be required to divest those subsidiaries involved in activities not authorized by the Bank Holding Company Act.

This transition rule would have a salutary (and perhaps indispensable) side effect: it would reduce the pressure on the markets in Treasury securities and commercial paper that would arise if many large financial corporations simultaneously attempted to separate their deposit and lending activities. A 10-year transition, for example, would allow all 35 of the leading banks to convert their banks to FHC depositories by collectively shedding roughly \$75 billion in loans each year. This is approximately the same amount by which the total volume of short-term Treasury securities and commercial paper issued by nonfinancial corporations has increased annually since 1981.

A transition period would also minimize the disruption in the monetary control functions of the Federal Reserve. Currently banks that fund their loans with deposits have the ability to create money simply by extending new loans. The Federal Reserve controls this money creation process by requiring banks to set aside a fraction of their deposits as reserves. The reserve requirement determines the amount by which any given amount of bank reserves can be "multiplied" by the private banking system. For exam-

Figure 2b. Structures of Diversified Banking Organizations Under Proposal



ple, with a 20 percent reserve requirement, a dollar of bank reserves can be multiplied through a process of lending and relending to a maximum of five dollars.

My proposal would reduce the money multiplier to the extent existing banks were converted to FHC depositories; because they could not themselves extend loans, they also could not create money. Uncertainty about the number of conversions would introduce uncertainty about the money multiplier itself, further eroding the usefulness of monetary aggregates as targets for monetary policymakers. A 10-year transition rule for converting existing commercial banks to the equivalent of money market funds would smooth much of the disruption in the money multiplier that these conversions would otherwise cause.

Anticipated Objections

Several criticisms of the proposal can be anticipated. Perhaps the strongest objection is that separation of deposit-taking and lending activities would lead to increased interest rates on commercial and consumer loans, since lending subsidiaries would be forced to rely on uninsured debt and equity rather than on less expensive federally insured deposits. The amount of any increase would depend, in significant part, on the number of banking organizations that converted their status. Many banks, including smaller institutions exempted from the separation requirements, would choose to remain as they are, funding their lending activities by insured deposits. These conventional banks would constrain the abilities of FHC lending subsidiaries to charge significantly higher interest rates.

One way to prevent consumer loan rates, in particular, from increasing would be to permit FHC-owned depositories to extend consumer loans. This variation would be

less attractive than separation of lending and deposit-taking services.

Another possible objection is that few, if any, banking organizations would choose to operate as FHCs, given the severity of the separation requirements. There is, of course, no way to test this proposition without making the FHC option available. Nevertheless, it is highly likely that many large banking organizations — as well as certain nonbanking companies — would seriously consider the idea. The FHC option would allow participants to obtain the benefits of portfolio diversification and to cross-sell each of the services and products offered by all of the nonbank affiliates, the principal reasons banks in particular have sought greater financial product-line freedom. And while it is true that FHC lending affiliates would have to pay more for their funds than conventional commercial banks, there is ample room in the credit markets to accommodate them. The strong success of GE Credit, currently one of the 10 largest commercial lenders in the United

States, proves that access to insured deposits is not a necessary condition for competing in the commercial lending business.

A final potential objection is that although Congress would clearly need to enact new legislation to authorize the unrestricted ownership of consumer banks, creating the FHC option may be unnecessary because there is nothing in existing law that prevents banks or their holding companies from shedding their loan portfolios and converting their depositories into money market funds. This observation is true but misses two important facts.

First, it is unclear whether a national bank currently engaged in both deposit-taking and commercial lending could legally retain its bank charter if it were to shed its entire loan portfolio. (This issue may be resolved in the current litigation pending in a Florida federal district court involving a challenge to the comptroller's authority to issue charters to nonbank banks.) Second, and more important, banking organizations have little incentive to incur the expense of restructuring their banks as long as they believe that Congress will at some point in the near future widen their financial product-line authority without requiring the separation of their payments and lending activities.

If my projections about the future political environment are correct, however, federal lawmakers will continue to be reluctant to intervene in the war between banks and other financial interests. As a result, banks will more than likely have to wait until the liberalizations of state bank charters induce Congress to level the playing field for national banks and bank holding companies. By that time the competitive positions of banks will be even further eroded. If banks instead were to fight for the FHC option, they might be able to allay the concerns of those who have opposed bank powers and thereby hasten the removal of the remaining impediments to product-line competition in the financial services industry.

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equivalent to the recent proposal offered by the Treasury Department to permit any type of company to own and operate a "consumer" bank. Although it has thus far been opposed by Federal Reserve Board Chairman Paul Volcker, who fears the consequences to the financial system of eliminating the distinction between banking and commerce, the consumer bank proposal has the political advantage of appearing less radical than requiring FHCs to separate all their lending operations from their deposit-taking activities. However, because it would be less far-reaching, the consumer bank concept could also fall short of meeting the concerns of those opposed to broader bank powers.

For example, although a consumer bank could be totally insulated from any nonbanking affiliates, it could still indirectly prop them up by extending loans to their customers. Banks affiliated with retailers could favor customers of those retailers in extending loans. A depository restricted to investing in high-quality marketable instruments could not exploit this potential conflict of interest. Moreover, given their ability to fund consumer loans with insured deposits, FHCs that owned consumer banks could grow larger than those that owned lending affiliates that had to rely on uninsured sources of capital. For those concerned about the effects of deregulation on the concentration of assets, therefore, the consumer bank proposal should be

Reform or Rhetoric: Gorbachev and the Soviet Economy

Ed A. Hewett

"Economic management, and this is obvious, needs constant improvement. But now the situation is such that measures limited to partial improvements are unacceptable. What is necessary is a radical reform."

— Mikhail Gorbachev at the XXVII Party Congress.¹

"Under Soviet socialism we pretend we work, and they pretend they pay us."

— A Soviet worker who would prefer to remain anonymous.

MIKHAIL GORBACHEV says that this sort of pretending is a luxury the Soviet Union can no longer afford. National income growth rates are on a clear downward path, making choices about allocating resources among defense, investment, and consumption increasingly difficult. In many areas Soviet technology is years, even decades, behind the Western industrialized world. An increasingly sophisticated Soviet population, politically very forgiving by world standards, nevertheless shows an unmistakable eagerness for something better out of its system. A Soviet military, which can ill afford to pretend, sees hard-won military parity with the United States threatened as President Ronald Reagan mobilizes awesome American industrial capacities in the service of the Strategic Defense Initiative. For all these reasons Mikhail Gorbachev is a man both serious and in a hurry as he sets out to address long-standing problems in the Soviet economic system.

At the same time, he is a creature of this system, respects its very impressive historical record of economic performance, and has no intention of discarding it. His approach includes not only economic reforms but also increased discipline, personnel changes, administrative streamlining, and a reinvigoration of the Communist party apparatus. In many ways Gorbachev and his supporters are engaged in an undeclared but very real war against ill-defined, shifting coalitions who pay lip service to his initiatives but employ delaying tactics and outright sabotage to dilute the impact of those initiatives. Not all the battles in this war are public, nor are the sides or their goals always apparent.

That uncertainty plagues Western efforts to understand what is happening now in the Soviet Union. Gorbachev's obvious dissatisfaction with the performance of the system and his frequent speeches calling forcefully for reforms all testify to a determination to take a dramatically new approach to economic affairs. But declarations of intent mean little unless they are translated into policy, and policy that is made to stick. And it is here, on the various battlefields that determine the actual fate of an economic reform, that a picture, admittedly very fuzzy, is beginning to emerge. That image shows an approach to the Soviet econ-

Ed A. Hewett is a senior fellow in the Foreign Policy Studies program at Brookings. He is the author of *Energy, Economics, and Foreign Policy in the Soviet Union and Reforming the Soviet Economic System* (forthcoming).

omy that is far more traditional than Gorbachev's speeches would suggest and well short of the radical reforms he says he wants. It is too early to say with certainty whether this picture reflects the early stage of the reform effort, a grand strategy in which Gorbachev starts slowly for political reasons and then moves into more radical reforms, or a genuine gap between rhetoric and reality that will grow. But there is ample information to form a preliminary judgment.

Gorbachev's Problem

Gorbachev has two basic economic goals. He needs higher growth rates to ease the choices he faces. And he needs an across-the-board improvement in the quality of goods and services both to meet the demands of an increasingly sophisticated populace and to support the efficiency gains that are the only possible foundation for the growth acceleration. The indispensable precondition to meeting either of these goals is a dramatic acceleration in the rate of technological change. Gorbachev knows that many things must happen before that acceleration can occur. He also knows that he has inherited an economy with some very real strengths that he would like to preserve, but some glaring weaknesses he is compelled to address. His problem is that the strengths and weaknesses are intertwined.

The most impressive strength of this system is the economic security it provides the population. Involuntary unemployment is virtually nonexistent in the USSR. Indeed, the demand for labor is such that most workers know they can find new jobs with ease. Furthermore, Soviet workers do not fear for their jobs as many Western workers do. Enterprises do not fail in the USSR either because of cyclical downturns or because no one is buying their goods. Enterprise management may come and go, but enterprises are secure. Finally price stability and a fairly steady growth in living standards have been hallmarks of the system for a half century.

These add up to a level of economic security to which any society could justifiably aspire. Gorbachev understands that whatever he does to reform the system, he must somehow manage to preserve, in spirit if not precisely in its current form, this economic security.

On the other side of the balance sheet there are clear signs that the system, precisely in its current form, is increasingly an anachronism in the modern economic world. The quality of goods and services produced varies greatly. The technology behind the automatic clothes washer seems to elude Soviet producers; the technology of modern nuclear and conventional weapons does not. In many industrial technologies the Soviets lag woefully behind the West; yet in some the West learns from them. Gorbachev realizes that the Soviet economic system does not automatically foster innovations; the state forces technological change by throwing scarce economic and political resources behind particular sectors and products. Without those commitments technology tends to stand still, and — as a consequence — so do product quality and efficiency.

Gorbachev seeks to change the situation so that innovation in products and processes is the norm, not the exception. But to accomplish that goal he must address a difficult dilemma. The natural tendency toward innovation exhibited in many Western countries comes because companies that do not innovate risk failure. Economic insecur-

ity plus economic autonomy are the parents of innovation. Take away the insecurity, say through government regulations, subsidies, or import barriers, and the incentive to innovate is weakened. Yet the essence of Soviet central planning is to protect enterprises and their workers from competition and the possibility of failure, which effectively institutionalizes a bias against innovation.

The Soviet leader is trying to do what quite possibly cannot be done. He is setting out to devise effective stimuli for innovative behavior that do not threaten the economic security the system provides. Put another way, he is searching for a trade-off between efficiency and equity significantly different from that existing in many Western countries, but also different from that existing in the Soviet Union. And many of the apparently contradictory measures Gorbachev has taken, his hesitations, and some inconsistencies in his public statements can be traced to precisely this dilemma.

The Strategy

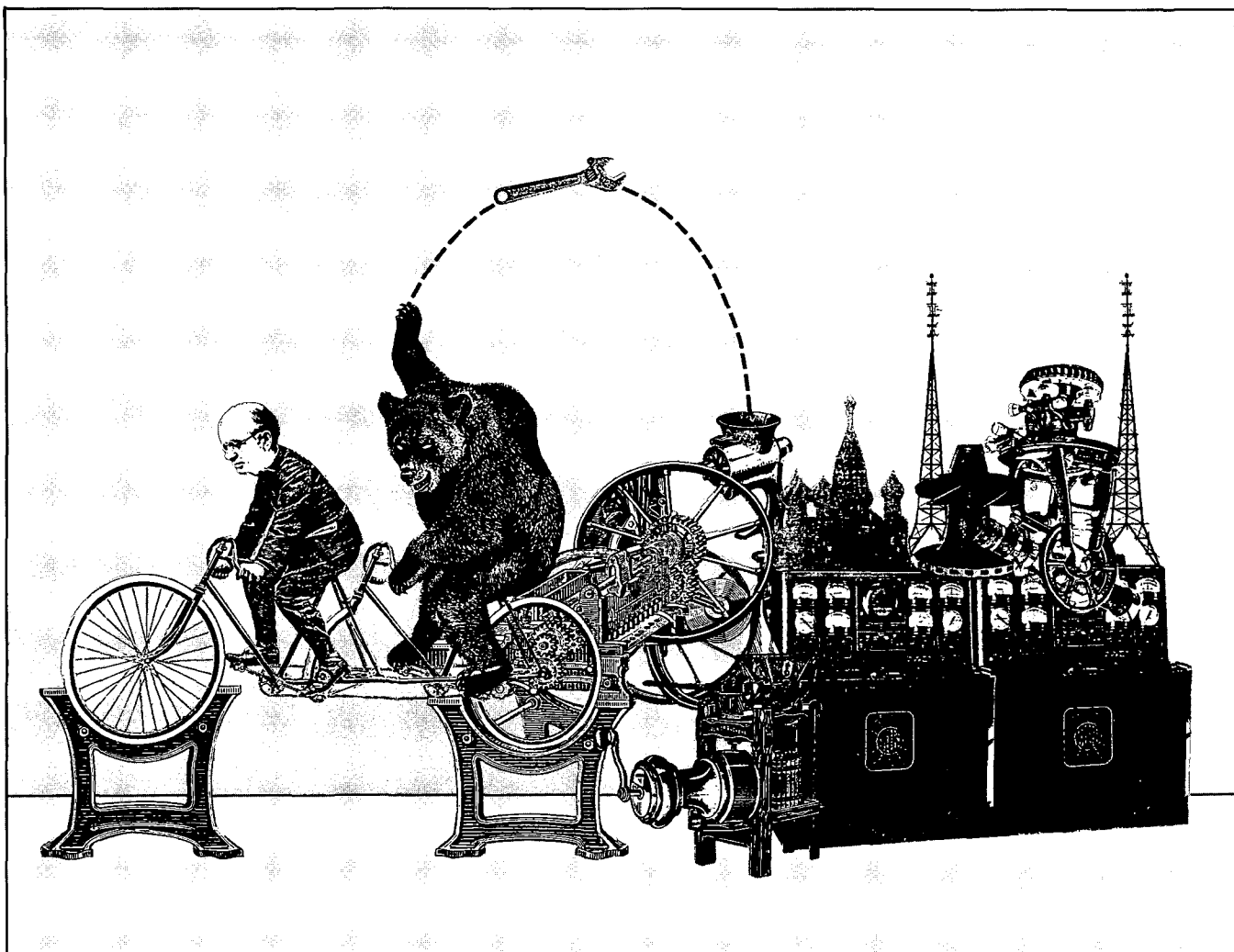
Mikhail Gorbachev assumed the post of general secretary on March 11, 1985, and by June he had already outlined his approach to the economy.² Many of his public statements since then have filled in some details without significantly changing the general conception. Those details fall into two general categories: changes in policy and personnel designed to foster a new approach to the economy, and reforms in the system itself. To be sure, there is a noticeable gap between measures announced to date and Gorbachev's rhetoric. But to measure that gap, it is useful first of all to outline Gorbachev's strategy as he describes it.

The 'Human Factor'

Gorbachev clearly feels that an important causal factor behind the economic problems he inherited lies in something that went wrong in the 1970s, something that had little to do with the system itself and much to do with mistakes in economic policy and a gradual deterioration in discipline, both directly attributed to Leonid Brezhnev's leadership.

The general notion is that the society as a whole has slipped into habits of shoddy work, and very little of that. In particular, the notion that something went wrong under Brezhnev is quite popular, and quite possibly right. Gorbachev believes it is time to sober up the work force and rekindle each person's sense of responsibility for, and pride in, his work. This is not an unpopular theme in Soviet society; the continuing nostalgia about Stalin probably stems in part from a feeling that the discipline under his rule has lamentably disappeared.

As a consequence Gorbachev believes that he can achieve quick and dramatic turnarounds in growth and the quality of goods and services by exploiting what he calls the "human factor": filling key posts with new personnel who will bring new ideas and a new vigor to their jobs, and increasing discipline through higher expectations and greater accountability. An anti-alcohol campaign is a critical component of this program. But there are other important elements: for example, giving enterprise directors the right and incentive to reward hard work and penalize slackers, and increasing pressure on local party organizations to play their intended role as both controllers and cata-



lysts for economic organizations under their purview.

In addition to this bundle of "human factor" policies, Gorbachev clearly intends to alter dramatically what he regards as a disastrously mistaken investment policy under Brezhnev. Gorbachev is particularly concerned about the low priority given to investment in machine-building itself; a continued tendency to build new plants, rather than to modernize existing plants, even when there is a chronic shortage of labor to staff the new plants; a construction industry prone to chronic cost overruns and very long construction periods; and a general bias throughout industry favoring existing, generally obsolete, technologies. While some of these problems can be dealt with only through systemic reforms, many can be at least partially addressed through policy changes implemented by the state planning apparatus.

Systemic Reforms

While Gorbachev expects the "human factor" to produce fairly rapid improvements in economic performance, he understands that systemic reforms are required to build a firm foundation for sustained improvements in growth and the quality of goods and services produced. He wants to create a system that enhances central control over the strategic economic variables of most importance to the lead-

ership (such as the rate of investment, its general structure, and basic directions of technological development), while leaving to lower-level decision-makers the authority and responsibility to decide on issues of a lesser magnitude but nevertheless of great importance to economic performance. This is the notion behind his oft-repeated desire to strengthen the center and increase the independence of enterprises, at the same time enhancing direct responsibility of enterprises for decisions taken with that newfound independence. Implicit in this formulation is Gorbachev's intention to link enterprise performance and workers' earnings, which logically leads to a weakening of the "safety net" that has protected all enterprises and their workers in the past.

An enormously complex, multilevel bureaucracy tightly controls economic activity in the Soviet Union. Basic goals for the system are set by the Politburo of the party. General plans for five-year, or longer, periods and very detailed annual plans that actually guide the operation of the system are developed by Gosplan (the State Planning Committee), in concert with other central organs. Approximately 50 ministries supervise all important enterprises in the country. The chief purpose of the planning process is to achieve balance between the supply and demand for key commodities, or commodity groups. The central planners assign supply tasks and purchase rights among the

ministries, who in turn pass a multiplicity of targets down to each enterprise in the form of an obligatory annual plan.

The enterprises also receive bonus schedules for fulfilling and overfulfilling various goals in the plan, an explicit acknowledgment that planners have imperfect information concerning enterprises' production possibilities, which in turn leaves enterprises room to maneuver among potentially inconsistent plan targets. In addition to the plan document itself, ministries and their subdivisions are in constant contact with enterprise management on matters large and small so that many operational decisions and all major investment decisions are jointly made with ministry officials, and quite possibly with local party officials.

Gorbachev understands that this system is extraordinarily cumbersome and increasingly dysfunctional. It stifles local initiative, which is obviously a brake on technological change, by creating the understandable assumption that the center is the source of all initiatives. Even worse, it channels whatever entrepreneurial skills there are into searching for ways to fulfill plan targets with minimal effort, which inevitably leads to "new" products that are not new and technical "innovations" that are not innovative. Gorbachev and many other Soviets have come to regard the ministries and their departments as the central villains in this system, primarily because of their seemingly insatiable desire to interfere in even the smallest decisions taken by enterprise management.

Gorbachev's cure is built around this diagnosis of the problem. He intends to retain the central planning organs and the ministerial system, but in a streamlined form and with different functions. Gosplan is to get out of the business of planning the production and distribution of individual commodities. Instead it will focus on assuring financial balance in the system, determining the major economic instruments such as tax rates and the distribution of funds for investment, and directing structural change in the economy. The ministries are to get off the backs of enterprises, using somewhat slimmer staffs to encourage the widespread introduction of world-level technologies.

Enterprises are to be given considerably more autonomy in making decisions on investment and in setting the terms of the contracts they sign. They will still receive plans from central authorities, but the emphasis is to shift from annual to five-year plans, and from detailed quantitative targets to financial norms set for five-year periods (for example, a schedule for a profits tax, or a norm linking the permissible level of wage payments to enterprise sales and productivity growth rates). Investments are to be financed primarily from retained enterprise earnings and bank loans (considerably reducing the role of budgetary grants for investments). And the current procedure of subsidizing unprofitable enterprises through profits confiscated from successful enterprises is to be quickly phased out. Furthermore, the intention is to move to a system in which enterprises must satisfy customers, not ministers, in order to earn funds for bonuses to workers and managers and for self-financed investment.

Consistent with these changes, prices are to be used to reward enterprises that produce high-quality products and to penalize those that retain obsolete or low-quality products in their production mix. Banks are to be given a more active role, consistent with retaining central control over the level and allocation of investment funds.

Just as interesting as what Gorbachev has said about reforms is what he has left unsaid. Critical issues relating to economic security have not yet been addressed. What, for example, will be the fate of enterprises that fail to satisfy their customers and therefore cannot meet their payroll and other obligations? If Gorbachev means what he says, then workers in these enterprises might find themselves looking for other jobs. Such a dramatic change in policy would require assurances of unemployment insurance along with retraining for workers let go by those enterprises. Gorbachev has not publicly addressed this question, nor has he talked about those enterprises that make large profits, or otherwise do very well. Will they really be allowed to keep the fruits of their success, even at the risk of exacerbating inequalities in the system?

It is also clear, from what Gorbachev has both said and not said, that he does not intend to imitate the Hungarian economic reform model, which virtually abolishes the ministerial system and moves to a system in which enterprises operate without an obligatory plan from the center. Nor has he indicated a willingness to follow the Chinese in their dramatic shift from collectivized agriculture to a decentralized system emphasizing family farming. However radical his intentions may seem to those Soviets who read his speeches or feel the first effects of measures introduced, they are more modest than what has actually been introduced in Hungary and China.

Implementing the Strategy

Gorbachev has not indicated the date by which he hopes to have his reforms in place. It takes time to design reforms and draft the decrees. In addition, as Gorbachev openly discussed in a speech to the Central Committee Plenum in June 1986, there is considerable opposition to be overcome, and much "consciousness-raising" yet to be done.³ It is probable that Gorbachev aims to have all major reforms in place by the end of 1988, which means they will not really take hold until the end of this decade.

That, in turn, implies that the human-factor and policy changes will carry the burden of the effort to fulfill the very ambitious five-year plan for the years 1986–90. National income growth rates, which averaged 3.2 percent in 1981–85, are targeted at 4.1 percent; labor productivity growth rates in industry, which averaged 3.1 percent during 1981–85, are set at 4.6 percent during 1986–90. Investment in machine-building during 1986–90 is to be 1.8 times higher than it was in 1981–85, allowing the replacement of half of all capital in those industries by 1990. The rate of introduction of new products throughout the system is also projected to increase dramatically.⁴

Personnel and Policy Changes

So far the most remarkable aspect of Gorbachev's approach has been the speed with which he has changed personnel throughout the economic hierarchy. Between March 1985, when he assumed the post of general secretary, and February 1986, when the XXVII Party Congress convened, Gorbachev appointed a new chairman of the Council of Ministers, six of the 12 deputy chairmen, new leaders in the key ministries and state committees in charge of the planning process (most notably the State Planning Committee, the

State Committee for Material-Technical Supply, and the ministries of Foreign Trade and Finance), and 19 of the 48 ministers directly supervising productive enterprises. He has appointed the majority of the Politburo and all but two of the Central Committee party secretaries.

Active efforts to exploit the human factor are more difficult to measure but are clearly occurring. Most notable is the tenacious pursuit of the anti-alcohol campaign begun in May 1985, in which the Soviet elite is expected to set an example. Anyone who visited the Soviet Union before 1985 and returns there now will be struck by the changes, symbolized by nonalcoholic lunches and a scarcity of alcohol at banquets. Liquor stores do not open until 2:00 P.M., and close by 7:00 P.M. Vodka production is to be reduced and soft-drink production increased. Retail outlets no longer can count liquor sales for purposes of bonuses. These changes are a remarkable attack on a very deeply entrenched, widespread use of alcohol in Soviet society. Whether in fact they will actually decrease heavy drinking or reduce the incidence of drunkenness on the job remains to be seen.

On the policy front Gorbachev began to impose his views on a very reluctant bureaucracy while he was still the "second" secretary under Konstantin Chernenko. The five-year plan that has finally emerged, after a number of drafts and the dismissal of the longtime head of Gosplan, Nikolai Baibakov, in general contains targets that one would expect given Gorbachev's stated goals. Investment in machine-building and metalworking is to be dramatically increased, and old equipment is to be quickly replaced by advanced technology (numerically controlled machinery, automated assembly lines, and robots). Existing plants are to be rebuilt rather than new ones constructed.

Economic Reform Decrees

The major economic reform decrees have only begun to flow. The general process is being managed through a Council of Ministers Commission on the Improvement of Management, Planning, and the Economic Mechanism,

chaired by N. V. Talyzin, the chairman of Gosplan and a first deputy chairman of the Council of Ministers.⁵ The reform commission supervises the development and drafting of decrees, presumably working closely with Central Committee staff, and presents proposed final decrees to the Politburo and the Council of Ministers for approval.

Some decrees have already been published, although the most important ones are yet to come. One of the earliest, issued in July 1985, was the one that gave individual enterprises more autonomy over their operations and small investments and ordered ministries to stay out of the daily affairs of the enterprises.⁶ It also set up the bonus-penalty scheme to encourage production of new goods judged to be of world-class quality. Work on this decree probably predated Gorbachev's appointment as general secretary, but the document seems to have his stamp, presumably because he was already quite influential on these matters under Chernenko. No other important decrees were issued until late 1985, when elements clearly related to Gorbachev's strategy began to appear.

Progress has already been made on creating organizations designed to facilitate cooperation among the multitudes of ministries that supervise individual economic units. In October 1985 a new *biuro* was created to supervise the 11 civilian machine-building and metalworking ministries.⁷ In November six ministries that supervised much of agriculture and the agro-industry were combined into a "superministry" known as Gosagroprom (State Agro-Industrial Committee).⁸ In March of this year, a fuel-energy bureau was set up to supervise the five ministries responsible for fuel and energy production.⁹ With these three reorganizations and others that may soon be announced, Gorbachev is trying to bring about the intersectoral cooperation and coordination so obviously lacking in the system for many years.

Among the other decrees that have so far been published, three stand out as important indicators. One announced in March gave somewhat more autonomy to farms to dispose of and benefit from production that exceeded planned targets. Nonetheless, much of the existing

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system of centralized control, now managed through Gosagroprom, remains.¹⁰ A reform set to take effect on January 1, 1987, puts light industry on a self-financing basis.¹¹ Plan targets will be reduced and contracts with retail outlets will become the most important determinant of bonuses for both management and workers.

A July 1986 decree announced important changes in the nationwide quality control mechanism, tightening up the procedures enterprises must follow to have products certified as being of the highest world standards.¹² The quality control system is intended to compel enterprises to produce goods at or close to world standards, even though these enterprises almost never enter into direct competition with the world's best producers of similar products. The existing quality certification system relies heavily on quality boards effectively controlled by the ministries responsible for the enterprises, which has the obvious disadvantage that the ministries are not disinterested in the outcome. The new system seeks to enforce much tougher standards by shifting power from ministries and suppliers to the State Committee on Standards (Gosstandart), which had formal control under the old system, and to customers and quality control inspectors in factories. Because substantial bonuses or penalties for enterprises ride on these certifications, they will be an important element in the new economic system.

Many of the most important decrees are still under con-

sideration in working groups of the reform commission.¹³ A new law on enterprises under discussion is expected to specify the rights of enterprises vis-à-vis ministries; it may be issued later this year or early next year. A major price reform is under discussion which, if the more radical members of that working group have their way, will result in a significant decentralization of price-setting authority and increased flexibility in the system. Changes in the financial and credit system are in the early stages of discussion. Reforms of the antiquated system now managing Soviet economic relations with other countries are also under active consideration. Other decrees relating to the planning bureaucracy and the ministries are apparently being discussed. A law on private economic activity is likely.

Words vs. Deeds: A Preliminary Assessment

Soviet and East European economic history suggests that reforms usually fail, or at least fall far short of their goals, for one of three reasons. The first, and most important, is that badly designed reforms build in inconsistencies that ultimately lead to recentralization. Enhancing the autonomy of enterprises without simultaneously introducing a price reform is a good example. When enterprises exercise their newly won autonomy, disequilibrium prices lead them in the wrong direction, and planners naturally respond via direct intervention.

Second, even well-designed reforms are threatened by bureaucratic guerrilla warfare. Party and government bureaucrats claim to support a reform and then use a rich range of devices to sabotage it. Poorly designed reforms are the easiest targets because they create problems that opponents can use as excuses to return to old ways of doing business.

Finally, reforms that survive these two hurdles face a third obstacle: the reluctance of the leadership to enforce politically unpopular reforms. Will Soviet leaders, for example, allow poorly run enterprises to fail and poor workers to lose incomes or even their jobs? It is here that the reduction in economic security necessary to improve system performance must be introduced, something that Soviet and East European leaders find understandably difficult to do.

Because the Gorbachev reforms are at such an early stage, one can only attempt to assess their design; bureaucratic opposition and a test of political will are still primarily matters for the future. And because the design is not yet fully revealed in the decrees, a final judgment on that score cannot be formulated. But it is possible to identify what might be called "leading indicators" regarding design, drawing on the decrees, Gorbachev's speeches, and the twelfth five-year plan. And those, while not unambiguously negative, are generally not encouraging concerning the internal consistency of the overall reform.

In the first place, because he is in a terrible hurry, Gorbachev has decided to press simultaneously for dramatic improvements in product quality and an acceleration in growth rates. Historically Soviet economic policy has focused primarily on achieving high growth rates, a priority so firmly built into the plans and other signals sent directly to enterprise managers that it has become a cornerstone of managerial mentality in the USSR. Managers

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have thus shown an understandable tendency to focus on high growth rates at the expense of product innovation. Now Gorbachev is calling for even higher growth *and* dramatic quality improvements, continuing the old emphasis and adding another "first" priority.

Yet quality improvements frequently entail short-term losses in the growth of output, and growth accelerations are probably easiest to achieve using old, familiar technology, making it almost certain that managers and their supervising ministries will have to choose one priority over the other. Instinct alone would push them in the direction of high growth at the expense of quality. Gorbachev's constant emphasis on the growth acceleration will confirm their instincts.

At the same time, managers will do their best to appear to be improving quality, which means they will learn to "work" the new quality control system. And that system, while possibly somewhat more leakproof than the bureaucratic sieve it replaces, still offers ample opportunity for a skillful manager to slip through "new" products that are nothing of the sort. A system that uses bureaucratic mechanisms to try to achieve world levels in technologies is a very poor substitute indeed for the much more unforgiving standards set by competition in world markets.

Gorbachev may see his growth rate targets fulfilled, and he will probably receive reports from Gosstandart that the quality of goods and services has improved dramatically. But more than likely the military, consumers, and industry as a whole will complain that quality is not much better than it was before.

A second and very important design flaw concerns conflicting messages on the relationship of ministries to enterprises. At the same time they exhort ministries to refrain from interfering in the daily affairs of enterprises, Gorbachev and other leaders tell the ministries to make sure that "their" enterprises meet or exceed targets for the introduction of new technology and the improvement of product quality.¹⁴

Given those expectations, any minister, no matter what the law or Soviet leaders say, would be foolish not to remain deeply involved in the affairs of enterprises under him. As long as he is held responsible for the performance of those enterprises, he will of necessity stay involved in their decisions. First secretaries for local party organizations, always deeply involved in enterprise decisions, are facing similar pressures and will respond in a similar fashion. Together the ministries and party organizations pose a formidable barrier to the expansion of enterprise autonomy, which is a basic component of Gorbachev's new economic direction.

A third apparent design flaw lies in Gorbachev's decision to retain the old, very complicated organizational structure of the central bureaucracy — albeit with a new leadership, and some "umbrella" organizations — giving to it the task of reforming itself. It would appear that the primary duties for drafting reform decrees affecting various sectors have been assigned to bureaucracies in the relevant ministries. In effect, each sector or each part of the planning apparatus is being asked to reform itself according to the principles of the Gorbachev reforms. That weakness gives the bureaucratic guerrilla warriors all the ammunition they need to delay and ultimately distort the reforms actually introduced into the system. The first signs of such behavior have already surfaced; Gorbachev complained at the June 1986

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Party Plenum of opposition and foot-dragging throughout the system, as the bureaucracy moves with "painful" slowness on his reforms.

So it appears that even at this early stage Gorbachev's reforms are already burdened with potentially fatal contradictions. The great irony is that many of the flawed approaches emerging in 1986 strongly resemble the failed reforms developed under Alexei Kosygin two decades ago. Then, as now, ministries were held responsible for what enterprises did but told not to interfere. Then, as now, the bureaucracy slowed drafted decrees to "reform" itself. It is unfortunate that Gorbachev has not encouraged a retrospective assessment of the lessons from the 1965 reforms, which is making it distressingly easy simply to repeat the mistakes of 20 years ago.

Despite these warning signs, it is too early to say definitively that the Gorbachev reforms will ultimately suffer the same fate as the Kosygin reforms. Most important is the fact that the debate continues both within the bureaucracy and in the press. And the bounds within which the debate can roam are quite wide by past standards: the need for enterprise failures, transitional unemployment, and price flexibility along with some inflation are all topics under discussion. In Soviet society something that is under discussion is a live option.

Another important unknown is Gorbachev himself. How willing is he to learn and to adjust his reform conceptions to improve them? How determined is he to force the bureaucracy to draft decrees truly consistent with those conceptions? How much political power does he wield within the party? Events during the next year should tell us a great deal. Gorbachev should soon see that it would be better to choose between high growth rates and rapid improvements in the quality of goods, between enterprise autonomy and expectations for ministries, between the old administrative structure with its old habits and a new administrative structure with yet unformed habits.

Then the success of his reforms depends upon what his

“non-negotiables” are and how strong he is politically. If quality and technological change are the ultimate goals, not simply higher growth rates, and if enterprise autonomy is clearly understood as the most promising vehicle to address those goals, then the current reforms could be rather quickly superseded by another more far-reaching but simpler set of decrees of greater internal consistency that moves the Soviet Union closer to a radical reform. If, on the other hand, Gorbachev is not only a creature of the existing system, but also its captive, then we could well be in for a period similar to the second half of the 1960s, when the leadership declared the reform to be going well, even though, in fact, it was dying.

1. “Politicheskii doklad tsentral’nogo komiteta KPSS XXVII s’ezdu General’nogo sekretaria TsK KPSS tovarishcha Gorbacheva M.S.” (Political Report of the Central Committee of the CPSU to the XXVII Congress of the Communist Party of the Soviet Union. Report of the General Secretary of the CC of the CPSU, Comrade M.S. Gorbachev), *Sotsialisticheskaya industriya*, February 26, 1986, pp. 2–9.

2. The most important statements were Gorbachev’s speech to the Central Committee Plenum one month after he assumed the post of General Secretary (“O sozyve ocherednogo XXVII s’ezda KPSS i zadachakh, svyazannykh s ego podgotovkoi i provedeniyem. Doklad General’nogo sekretaria TsK KPSS M.S. Gorbacheva” [On the Convening of the Regular XXVII Congress of the CPSU and the Tasks Associated with its Preparation and Realization. A Report of the General Secretary of the CC CPSU, M.S. Gorbachev], *Pravda*, April 24, 1985, pp. 1–2) and especially his speech at a June 1985 special meeting at CC headquarters on the economy (“Korennoi vopros ekonomicheskoi politiki partii. Doklad General’nogo sekretaria TsK KPSS M.S. Gorbacheva” [The Fundamental Question of the Economic Policy of the Party. A Report of the General Secretary of the CC CPSU, M.S. Gorbachev]), *Literaturnaya gazeta*, No. 24, June 12, 1985, pp. 1–2.

3. “O piatiletnem plane ekonomicheskogo i sotsial’nogo razvitiia SSSR na 1986–1990 gody i zadachakh partiinykh organizatsii po ego realizatsii. Doklad General’nogo sekretaria TsK KPSS M.S. Gorbacheva” (On the Five-Year Plan of Economic and Social Development of the USSR for 1986–90, and Tasks of Party Organizations Concerning its Realization. Report of the General Secretary of the CC CPSU, M.S. Gorbachev), *Sotsialisticheskaya industriya*, June 17, 1986, pp. 1–4.

4. On the twelfth five-year plan see my “Gorbachev’s Economic Strategy: A Preliminary Assessment,” and Philip Hanson’s comment, in *Soviet Economy*, Vol. 1, (October–December 1985), pp. 285–312. That analysis was based on the draft of the plan published in November 1985. Since then a final version of the plan was approved as law; it generally follows the more ambitious end of the intervals outlined in the draft. See *Ekonomicheskaya gazeta*, No. 26 (June 1986), pp. 14–15.

5. Information on the workings of this commission comes primarily from interviews with Soviet economists during a visit to Moscow in July 1986.

6. “O shirokom rasprostraneni novykh metodov khoziastvovaniia i usilenii ikh vozdeistviia na uskorenie nauchno-tehnicheskogo progressa. Postanovlenie Tsentral’nogo Komiteta KPSS i Soveta Ministrov SSSR ot 12 Iulia 1985 No. 669” (On the Wide Diffusion of New Methods of Economic Management and the Strengthening of their Impact on the Acceleration of Scientific-Technical Progress. A Decree of the Central Committee of the CPSU and the Council of Ministers of the USSR on 12 July 1985, No. 669), *Ekonomicheskaya gazeta*, No. 32 (August 1985), insert.

7. The new *biuro* was announced in the summary of the minutes of the October 17, 1985, Politburo meeting (*Sotsialisticheskaya industriya*, October 18, 1985, p. 1). The *biuro* is

headed by I. S. Silaev, former minister of the aviation industry promoted to chairman of the Council of Ministers. The actual decree has not been published. However, a discussion of the responsibilities of the *biuro* can be found in an interview with Silaev: “Zadachi biuro po mashinostroeniui” (Tasks for the Bureau of Machine-building), *Izvestiia*, March 11, 1986, p. 2.

8. Gosagroprom is headed by V. S. Murakhovsky, a new first deputy chairman of the Council of Ministers. For a summary of the decree, “O dal’neishem sovershenstvovanii upravleniia agropromyshlennym kompleksom” (On the Further Improvement of Management in the Agro-industrial Complex), see *Pravda*, November 23, 1985, pp. 1–2.

9. The *biuro* is headed by B. Scherbina, also a deputy chairman of the Council of Ministers. Very little other information is available about this organization aside from the brief discussion in the report of the March 13, 1986, Politburo meeting. See *Pravda*, March 14, 1986, p. 1.

10. A summary of the decree, “O dal’neishem sovershenstvovanii ekonomicheskogo mekhanizma khoziastvovaniia v agropromyshlennom komplekse strany” (On the Further Improvement of the Economic Mechanism of Economic Management in the Agro-industrial Complex of the Country), is published in *Pravda*, March 29, 1986, pp. 1–2.

11. A summary of the decree, “Ob uluchении planirovaniia, ekonomicheskogo stimulirovaniia i sovershenstvovanii upravleniia proizvodstvom tovarov narodnogo potrebleniia v legkoi promyshlennosti” (On the Improvement of Planning, Economic Stimulation and Further Perfection of Management in the Production of Consumer Goods in Light Industry), was published in *Sotsialisticheskaya industriya*, May 6, 1986, pp. 1–2.

12. A summary of the decree, “O merakh po korennomu povysheniiu kachestva produktsii” (On Measures for a Radical Increase in the Quality of Production), was published in *Pravda*, July 2, 1986, pp. 1–2.

13. This discussion on forthcoming decrees also draws on recent meetings in Moscow with economists involved in the work of the reform commission.

14. Consider, for example, Nikolai Ryzhkov’s speech at the XXVII Party Congress (“Ob osnovnykh napravleniiakh ekonomicheskogo i sotsial’nogo razvitiia SSSR na 1986–1990 gody na period do 2000 goda. Doklad Predsedatelia Soveta Ministrov SSSR tovarishcha Ryzhkova N.I.” [On the Basic Guidelines for Economic and Social Development of the USSR in 1986–90 and in the Period until the Year 2000. Report of the Chairman of the Council of Ministers of the USSR, Comrade N.I. Ryzhkov], *Sotsialisticheskaya industriya*, March 4, 1986, pp. 1–5) in which he says when discussing the need to accelerate scientific-technical progress that ministries must “accept full responsibility for the technical level of production in their sectors” (p. 3). Somewhat later, when discussing economic reforms, he says ministries must restructure their operations, transferring part of their former functions to enterprises, freeing themselves from concerns about the daily affairs of enterprises, and “trusting enterprises more” (p. 4).

No School Is an Island: Politics, Markets, and Education

*John E. Chubb
and
Terry M. Moe*

WHAT MAKES some schools more effective than others? In the view of most educators and policy-makers, it is features of the schools themselves: school autonomy, strong leadership, clear school goals, rigorous academic requirements, an orderly setting, teacher involvement in school decision-making, high parental interest and involvement, and high expectations about student performance. These and related features have been shown in scholarly research to enhance school effectiveness.

State and local policy-makers, under considerable public pressure to do something about the decline in educational quality, are now working earnestly to impose these desirable features on their schools directly. Graduation requirements and homework policies are being made more rigorous. More highly qualified teachers are being sought with the help of better pay and proficiency exams. Principals are being trained to be stronger leaders, teachers exhorted to have higher expectations, and parents encouraged to play a more active role in their childrens' education.

But will these sorts of reforms work? We do not think so. We believe that schools are largely products of their environments and that the fundamental determinants of school effectiveness are to be found in the larger setting or system in which schools operate. Weak leadership, principal-teacher conflict, and other problems do not plague our public schools through inadvertence or misunderstanding or because the people involved are not highly trained or motivated. In most cases, no one is really at fault — the fault lies with the system. Until educational reforms move beyond a narrow focus on schools per se, they are doomed to the treatment of symptoms rather than causes.

The Public and Private Environments

The primacy of the environment is well illustrated by a comparison of public and private schools. They obviously have very different environments, offering a rich basis for comparison. In addition, they seem to have different levels of effectiveness: current evidence suggests that private schools are in fact more effective than public schools at educating comparable students. It is reasonable to expect, then, that private schools already tend to be characterized by precisely those organizational features that reformers have been urging on the public schools — and that it is the environmental differences between the two sectors that largely account for the organizational and performance differences.

In an effort to address these issues, we recently participated in the design of a large-scale survey of public and private schools. Our analysis of the survey will ultimately take the form of a book. This article is a midstream report, summarizing our theoretical arguments and preliminary findings.

John E. Chubb and Terry M. Moe are writing the forthcoming Politics, Markets, and School Performance. Chubb is a senior fellow in the Governmental Studies program at Brookings. Moe was a senior fellow in the same program until September, when he resumed his position as associate professor of political science at Stanford University.

Before we turn to the findings, exactly how would we expect public and private schools to differ? In our view, a good many differences can be anticipated by recognizing that the schools are controlled in fundamentally different ways: one by politics, the other by markets.

Public schools are governed by democratic authority and thus are properly controlled by and responsible to “the people,” particularly local citizens and their representatives on the school board. But this is not the schools’ only constituency. State and federal governments also have legitimate roles to play in financing, setting standards, and otherwise bringing their preferences to bear. Citizens everywhere, regardless of whether they have children or even live in the district, have a hand in governing the local school — as do their agents, the politicians and administrators who run the various levels and units of government. Public schools are obliged to respond to all these constituencies, however diverse, difficult to meet, and internally inconsistent their demands might be. Schools are administrative subordinates in a very complex system of political authority and control. About this, they have no real choice.

Private schools are not part of this system of governance. Generally speaking, they are owned and managed. Most have some sort of governing body that at least has the trappings of “democratic” control, but these are far different from those in the public sector. Private school constituencies are very small and homogeneous by comparison, and the relevant demands and constraints are substantially local. In the typical private setting, it is much clearer who is in charge and what the standards are — and those who disagree are free to seek educational services elsewhere.

The ready availability of the exit option is crucial, for when students and parents are afforded the opportunity to make choices among schools, a second mechanism of social control or governance is at work: the market. Democratic governance is one means by which society can try to shape the nature of its schools, the market is another. It provides direct incentives for private schools to please the immediate consumers of educational services, students and parents. Some of these consumers may place emphasis on academic excellence, others on discipline or work habits, others on religion. However it is segmented, market demand will tend to find its reflection in the supply of services by private schools.

This responsiveness to market demand comes about for two main reasons. First, tuition is a major source of revenue for most private schools. This forges a strong link between financial well-being and school performance, giving the schools important incentives to tailor their policies and programs — and to bolster their effectiveness — in ways that appeal to chosen segments of the market. Second, a natural selection mechanism is operating: even if many schools adapt poorly or unwisely to market demand, those that happen to be providing what people want will succeed and those that do not will fail (or, if subsidized, become small and uneconomical). Adaptation and natural selection combine to ensure that the pool of surviving schools will tend to provide the kinds of services demanded.

Public schools are almost always monopolists in their sectors and are largely sheltered from market forces. Because they are “free” and accordingly far less expensive than private schools, and because most parents are neither wealthy enough nor obsessed enough with education to

change their residence with changes in school quality, public schools have a semi-captive clientele with little choice but to patronize the local monopoly. This is particularly true of low-income citizens. Public schools are sheltered even further by the fact that their funding comes from political authorities via taxation rather than from parents as a fee for services rendered. Parents may complain about the quality of education, but they are not in financial control.

It is of great consequence that our society has chosen to control its schools through politics rather than markets. Because democracy involves many interests, constituencies, and institutional components, and because control is never automatic — requiring rules and regulations, monitoring, and other means of promoting compliance with democratic directives — social control of this sort is implemented through an extensive set of bureaucratic arrangements. The public education system is inherently bureaucratized. It is also very sensitive to the incentives that guide the decisions of politicians and administrators. Ever concerned with reelection and political support, politicians are inevitably responsive to powerful groups — like teacher unions — with strong views about how the system should be structured and operated, views that reflect their own financial and professional stakes. Administrators, for their part, tend to respect, defend, and promote the bureaucratic control mechanisms around which their very jobs are defined. The expressed interests of students and parents are but a small part of all this.

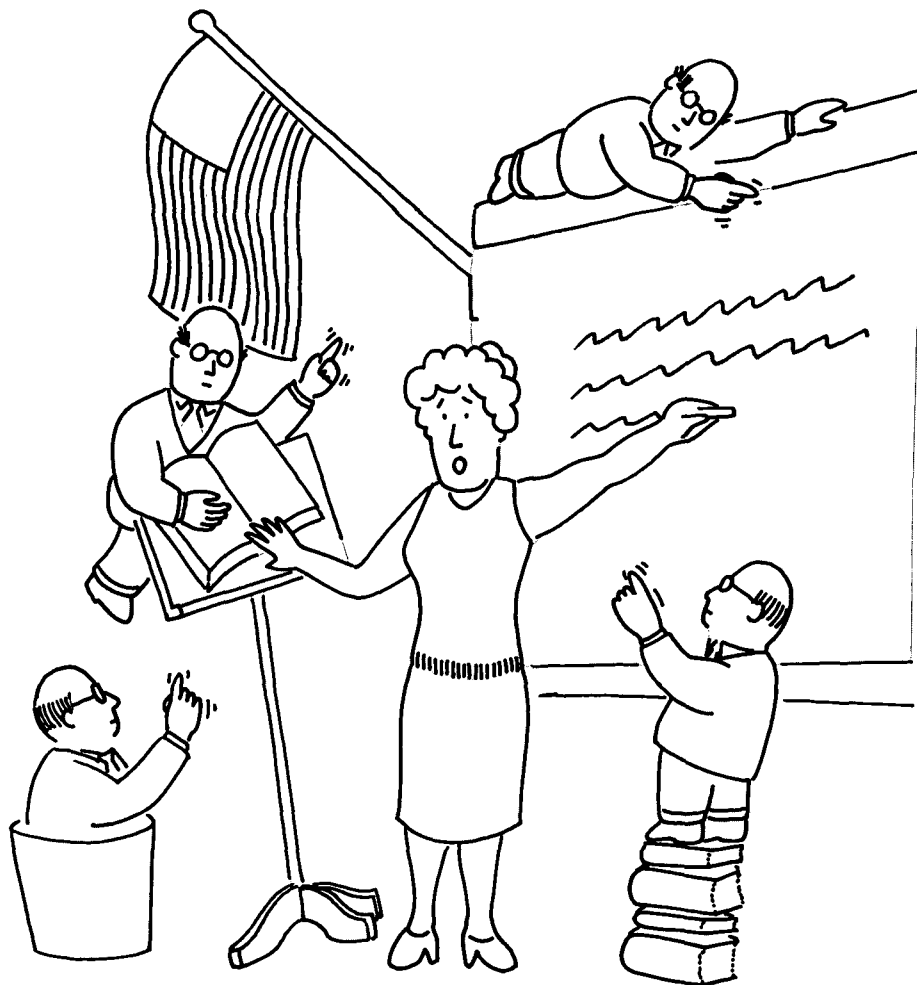
Control in the private sector looks very different. Because the typical school setting is much simpler, the number of participants smaller, and legitimate authority concentrated in the “owner,” the control problem is less onerous and requires a far less imposing bureaucratic apparatus, if any. More importantly, market forces encourage the development of schools that have the kinds of policies and organizational characteristics that parents and students find valuable. In this way, the immediate consumers of educational services can “control” their schools without any administrative apparatus or formal participation at all for directly imposing their preferences.

For reasons that this brief discussion has only begun to suggest, then, there appear to be fundamental differences in the environments of public and private schools due to their orienting structures of politics and markets, and these differences should have pervasive implications for the ways in which schools are organized and operated. In the sections that follow, we will elaborate this line of reasoning in greater detail, and, in outlining some preliminary results from the responses to our recent survey, suggest why we think the findings look as they do.

A New Survey

Our study builds upon “High School and Beyond” (HSB), a 1980 survey of more than 1,000 public and private schools and some 60,000 of their students. HSB was the basis for *High School Achievement*, an important book by James S. Coleman, Thomas Hoffer, and Sally Kilgore. It provides the most detailed as well as the most provocative and influential comparison of public and private schools to date. The central conclusion: private high schools promote substantially more learning — as much as one year’s worth — than public high schools do.

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HSB was expanded in 1982 by a follow-up survey of 25,000 seniors, whose test score changes from sophomore year to senior year provide direct measures of individual learning. This wealth of information on students, however, was not matched by comparable data on the organization and environments of their schools. If HSB was to be useful in explaining why private schools seem to perform more effectively, then comprehensive information was required on the schools and their larger settings.

To this end, we participated along with others in a project to supplement HSB with a new survey. Approximately 500 of the original schools were included in this study, with questionnaires administered to the principal and 30 teachers in each. The more than 11,000 responses to this "Administrator and Teacher Survey" (ATS) permit us to characterize the HSB schools in terms of many of the factors thought to encourage school effectiveness: relationships with parents and outside authorities, leadership, goals, structure, decision-making, and educational practices. If school performance is heavily influenced by environmental and organizational factors, the ATS and HSB surveys taken together will provide the best information ever assembled for explaining how and why — and for developing reforms with real prospects for success.

Below we outline some of our preliminary findings on the organization and environment of schools. For purposes of comparison, we break down the private sector

schools into three types: Catholic, Elite (high performance college prep), and Other Private (a catch-all category). Throughout we suggest why a "politics and markets" perspective helps explain the pattern of public-private differences. The more complicated task of linking all these characteristics to student performance is left to the book.

The Findings

External Authorities

If the operation of politics and markets suggests anything, it is that public schools should find themselves operating in larger, more complex governing systems and that these governing systems should tend to leave them with less autonomy and control over their own policies, structure, goals, and operation. It is a foregone conclusion that the first proposition is true when it comes to higher levels of political and administrative authority: public schools are part of state and federal governmental systems through various hierarchic and budgetary linkages, and private schools generally are not. But what about immediate outside authorities, those best situated to oversee and constrain the school at the local level?

Not surprisingly, virtually all public schools are hierarchically subordinate to school boards and to outside ad-

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ministrative superiors. The private sector is far more diverse. Almost all private schools, regardless of type, have a school board of some sort, but often there is no accompanying administrative apparatus. Such an apparatus is quite rare among the Elite schools and nearly half of the Other Private schools are similarly unencumbered. It is the Catholic schools that most resemble the public schools in this regard; some two-thirds of them have both school boards and administrative superiors.

These are reasonable and not altogether surprising patterns. But they tell us only that private schools are subject to fewer outside authorities; they do not tell us whether the authorities that private schools actually do face are any less demanding than those that public schools face. It turns out that they are less demanding indeed. On five basic policy dimensions — curriculum, instructional methods, discipline, hiring, and firing — school boards in the public sector appear to have more influence over school policy than they do in the private sector, regardless of the type of private school. The differences between public and private are consistently much greater for personnel and disciplinary policy than for matters pertaining to educational practice and content. It is similarly true that private school principals, relative to their school boards, play a more autonomous role in setting policy than public school principals do, and their autonomy is greater over personnel and disciplinary matters than over those concerning curriculum and teaching methods.

When it comes to the influence of administrative superiors, only Catholic schools have a bureaucracy sufficient to justify a comparison to public schools. Here we find that the famed Catholic hierarchy plays, by public sector standards, very little role in setting school policy. On all five dimensions, the influence of administrative superiors is far less in Catholic than in public schools, and Catholic principals have more autonomy in setting school policy than public principals do.

True, these are simple measures of influence. But the patterns they yield are quite uniform and entirely consistent with our expectation that public schools would be subject

to greater control by external authorities. The authorities that are so ubiquitous in the democratic context of the public school are often simply absent from private school settings, and even when they are an acknowledged part of the governing apparatus, they are less influential in the actual determination of school policy. Private schools, it would appear, have more control over their own destinies.

Choosing the Organization's Members

External authorities are by no means the only constraints that limit the ability of a school to structure and operate its organization as it sees fit. Two in particular — tenure and unions — restrict a school's freedom to exercise perhaps its most significant form of control: its ability to recruit the kinds of teachers it wants and to get rid of those who do not live up to its standards. Public schools are much more constrained in these regards.

Our survey shows that 88 percent of public schools offer tenure while only a minority of the private schools do. Among the schools that do offer tenure, moreover, the proportion of teachers who have actually been awarded it reflects the same asymmetry: 80 percent of the eligible teachers in public schools have tenure, while the figure is some 10 to 16 percent lower in the private sector. The differences in unionization are even more substantial. The vast majority of public schools are unionized — some 80 percent — almost all of them by either the National Education Association or the American Federation of Teachers. In the private sector, by contrast, teachers are rarely represented by unions. Only about 10 percent of the Catholic schools are unionized; virtually none of the Elites and Other Privates are.

These differences are anticipated by a politics and markets perspective. Tenure systems in public schools are special cases of the civil service systems that exist at all levels of government. Historically, these systems arose to prevent politicians from rewarding their supporters with public jobs. Reformers recognized that the widespread use of patronage was inconsistent with the kind of expertise, professionalism, and continuity so necessary to effective govern-

ment, and — in a halting process that took decades to accomplish — they brought about the pervasive adoption of civil service systems built around objective qualifications and designed to protect employees judged to be meritorious. Tenure is one of these protections.

Public education unions, although initially resisted by politicians wedded to patronage, eventually found political allies of their own. Unions could offer organization, money, manpower, and votes to politicians, and in state and local elections, where voter turnout is typically very low, these are attractive inducements indeed. As education unions thrived, they gained not only economic concessions but contractual guarantees of job security that reinforced the protections of the civil service system and introduced wholly new constraints into personnel decisions affecting the local school.

Although there is nothing to prevent unions from gaining a foothold in private schools nor to keep private schools from adopting tenure and other civil service-like protections, there is nothing comparable to government that drives them in that direction. Whether unions and tenure systems take hold in the private sector is determined to a far greater extent by the market. Schools may choose to offer tenure and other protections as a means of attracting good teachers, particularly given that public schools offer that benefit. But private schools may also decide, especially if the supply of teachers is high, that they can offer a very attractive set of benefits — such as good students, orderly atmosphere, and collegial decision-making — without offering tenure at all. As in any market setting, unions may or may not succeed in organizing teachers. But they cannot count on symbiotic relationships with the authorities, as public unions can, to help their cause.

To assess whether school control over personnel is perceptibly constrained by tenure, unions, and forces outside of the school, we asked principals to evaluate an assortment of potential barriers to hiring and firing teachers. Public school principals are more constrained in both respects. For instance, they face substantially greater obstacles in dismissing a teacher for poor performance than private school

principals do. The procedures are far more complex, the tenure rules more restrictive, and the preparation and documentation process roughly three times as long. Their complexity and formality make dismissal procedures the highest barrier to firing cited by public school principals. For private school principals the highest barrier is a personal reluctance to fire. These responses provide a rather poignant statement of the differences between the sectors: while the public school principal is bound most by red tape, the private school principal is bound most by his conscience.

Even if superintendents and central offices wanted to delegate greater control over teachers to public school principals — and, in general, there is no reason to think they have incentives to do this — many of these personnel decisions cannot in practice be delegated. In the public sector, tenure protections are usually guaranteed through laws that are written by school boards or state legislatures, and union contracts are typically bargained at the district level. Tenure and unionization tend to settle the question of when and how the basic personnel decisions will be made in the public sector. They will be centralized. In the private sector, schools are largely free of such constraints and have far greater flexibility to choose their own members and chart their own paths.

Parents

In most respects private schools would seem to have ideal parental environments. Parents, after all, have made a positive choice to send their children to a private school, presumably because they care about education and have a high appraisal of the school. And if at any time they change their views, they can exercise their option to exit. This means that the school is likely to enjoy significant gains: they gain children whose family lives encourage education and parents who not only will facilitate school objectives through monitoring and the like, but will be informed and supportive when they take an active interest in school decision-making. Parents who may cause problems are pre-

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cisely the ones most likely to drop out of the school's environment voluntarily.

Public schools are not so fortunate. Many of their students come from families that put little or no emphasis on education; the students come to school with poor attitudes and orientations, and the parents do little to facilitate the school's efforts. Because private schooling is often not a viable option, many parents who do not support the school's goals, methods, or activities will remain in its environment nevertheless — and some, perhaps many, will use the democratic mechanisms at their disposal (as well as interactions with principal and staff) to express their discontent and press for change. Far from gaining sustenance from a supportive parental environment, the public school may often find itself dealing as best it can with conflict, disappointment, and apathy.

Not all public and private schools will neatly fit these molds, of course. But it seems clear that characteristics inherent in the two sectors — characteristics anchored in politics and markets — encourage the kinds of environmental differences outlined here. The results from the ATS study are consistent with this line of reasoning. Parents in the private sector, regardless of the type of school, are uniformly more supportive of their schools. They have higher expectations about their children's educational performance, they are more active in monitoring their children's behavior outside of school, and they are more deeply involved with the school as an organization. Private school principals, not surprisingly, also express greater satisfaction with their parental environments. Relationships with parents are more cooperative than in the public sector and less restrained by the kinds of formal rules and norms that, due to democratic governing structures, impinge on the flexibility of public school principals. In short, the operation of politics and markets on parental environments appears to put public schools at a real disadvantage.

The Principal

The principal, more than any other single person, is responsible for negotiating successfully with the environment — for dealing somehow with demands and pressures from parents, unions, administrators, and school boards — and is widely regarded as a key to school effectiveness. Excellence in education appears to be promoted by a principal who articulates clear goals, holds high expectations of students and teachers, exercises strong instructional leadership, steers clear of administrative burdens, and effectively extracts resources from the environment.

Less often stressed, however, is that the school environment can have a lot to say about whether the principal is able to practice these precepts of effective leadership — or, for that matter, is even motivated to practice them. Effective leadership does not simply inhere in the individual filling the role; it is unavoidably contingent upon the demands, constraints, and resources that the principal must deal with. Depending on the nature and strength of these forces, even the “best” principal may have only a marginal effect on school performance.

We found substantial differences between public and private school principals. To begin with, private school principals have considerably more teaching experience — almost four years more for principals in Catholic schools,

and over five years more for those in the Elites and Other Privates. Private school principals also come to their jobs with different motivations than their public counterparts. They are more likely to stress control over school policies, while public school principals place greater emphasis on a preference for administrative responsibilities, a desire to further their careers, and an interest in advancing to higher administrative posts.

These differences in experience and motivation appear to shape the principal's performance as a leader. As judged by their own teachers, private school principals are more effective instructional leaders and are more likely to exhibit other basic qualities of leadership — knowledge of school problems, openness with the staff, clarity and strength of purpose, and a willingness to innovate.

From the standpoint of politics and markets, these findings make sense. In the public sector, the administrative hierarchy offers an attractive avenue for career advancement. Public school principals tend to disembark from teaching relatively early, get on an administrative track, and take the job of principal to keep the train rolling. Private principals are scarcely on a track at all. They stay in teaching longer, and their view of the principalship focuses more on its relation to the school than on its relation to their movement up an educational hierarchy.

Of course, these are not the only determinants of leadership. Public school principals are forced to operate in much more complex, conflictual circumstances in which educational success is more difficult to achieve regardless of the principal's (perhaps considerable) abilities. If anything, however, the public school principal's lack of teaching expertise and his hierarchic career orientation probably contribute to these leadership problems.

Goals and Policies

Given what we know of their environments, there is every reason to expect that public and private schools should adopt very different orientations toward the education of their students. Because public schools must take whoever walks in the door, they do not have the luxury of being able to select the kind of students best suited to organizational goals and structure. In practice this means that the pursuit of educational excellence must compete with much more basic needs — for literacy, for remedial training, for more slowly paced instruction. In addition, the hierarchic structure of democratic control ensures that a range of actors with diverse, often conflicting interests will participate in deciding what the public school ought to pursue and how. Private schools, largely unconstrained by comparison, should find it easier (if they want to do so) to place a high priority on excellence and, whatever their goals, to choose a set that is clear and consistent.

Our results confirmed these expectations. In terms of general goals, public schools place significantly greater emphasis on basic literacy, citizenship, good work habits, and specific occupational skills, while private schools — regardless of type — are more oriented toward academic excellence, personal growth and fulfillment, and human relations skills. These goals are also upheld by specific policies and are clearly discerned by the staff. Private schools have more stringent minimum graduation requirements; their students, regardless of track, must take significantly more

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English and history, science and math, and foreign language than public school students in order to graduate. In science, math, and foreign language the differences range up to two years. Private schools also have stricter homework policies. Ninety percent of all public schools leave the amount of homework entirely up to teachers. Finally, private teachers uniformly say that school goals are clearer and more clearly communicated by the principal than public teachers report; and they are more in agreement among themselves on school priorities.

All of these characteristics that private schools possess in greater abundance are stereotypical of effective schools. They are also characteristics that, due to the differential operation of politics and markets, would seem extremely difficult for public schools to develop in the same degree.

People, Decisions, Operation

Politics and markets cannot hope to tell us everything we might want to know about organizational structure and process, but they point us in a clear direction. The critical fact about the public school environment is not just that it is complex, but that it imposes decisions about policy, structure, personnel, and procedure on the school. Nowhere is this more apparent than in the control over the most crucial agent of organizational performance: the teacher.

As we have seen, the public school principal is far less able than his private counterpart to staff his organization according to his best judgment. This, in turn, should promote differences in staff heterogeneity and conflict. Public school teachers may reject the principal's leadership, dissent from school goals and policies, get along poorly with their colleagues, or fail to perform acceptably in the classroom — but the principal must somehow learn to live with them. When these teachers are represented by unions, as they normally are, leadership difficulties are magnified. Professionalism takes on new meaning: as a demand that decision-making power be transferred from the principal to the teachers. Private schools are not immune from personnel problems and struggles for power. But the fact that the

principal has much greater control over hiring and firing means that he can take steps to recruit the kinds of teachers he wants and weed out those he does not. It also means that teachers have a strong inducement to perform.

By comparison to his public school counterpart, the private school principal is better able to create a team of teachers whose values, skills, and willingness to work together tend to mirror those qualifications he deems conducive to the pursuit of organizational goals. At the same time, he is in a position to make teacher professionalism work for rather than against him. Without real threat to his own authority or control, he can encourage teachers to participate in decision-making, extend them substantial autonomy within their own spheres of expertise, and promote a context of interaction, exchange of ideas, and mutual respect.

The data from the ATS survey support this general line of reasoning. Private school principals consistently claim that a larger percentage of their schools' teachers are "excellent," suggesting that these principals are more confident in the abilities of their own staff members than public school principals are in theirs. Private sector teachers, in turn, have better relationships with their principals. They are consistently more likely to regard the latter as encouraging, supportive, and reinforcing. Private school teachers also feel more involved and efficacious in important areas of school decision-making that bear on their teaching. In particular, they feel more influential over schoolwide policies governing the curriculum, student behavior, teacher in-service programs, and the grouping of students of differing abilities. In their classrooms they believe they have more control over text selection, course content, teaching techniques, and student discipline. Even on matters of hiring and firing, private teachers believe they are more influential, despite the almost complete absence of unions in their sector.

Relative harmony between private school principals and teachers is matched by relative harmony among the private teachers themselves. On a personal level, relationships are more collegial in the private sector. Stated in the plain terms of the survey, private school teachers are more likely to believe they can count on most staff members to help out

anywhere, anytime, even though it may not be part of their official assignment, and that the school seems like a big family. On a professional level, private school teachers give greater evidence of mutual involvement and support. They are more likely to know what their colleagues are teaching, to coordinate the content of their courses, and to observe one another's classes. It should come as no surprise, then, that private school teachers also feel more efficacious than public school teachers, are much more satisfied with their jobs, have better attendance records, and tend to work for less money.

In short, private schools do tend to look more like teams. This is what the operation of politics and markets should lead us to expect.

Implications

These results stand to shed light on the puzzle of school performance and the prospects for school improvement. Previous research suggests that private schools outperform public schools and that differences in school performance are associated with differences in school organization. If this research is essentially on target, the results of the ATS survey are, at least in part, to be expected. Private schools turn out to have more of the organizational attributes — such as strong leadership, clear goals, a teamlike atmosphere — that are thought to enhance school performance than do public schools.

We have tried to do more, however, than simply present findings and relate them to existing work. We have also tried to make sense of these differences between public and private schools by arguing the logic of politics and markets. In the most general sense, this argument derives from our belief that environmental context has pervasive consequences for the organization and operation of all schools far more important than most of the literature suggests. More specifically it derives from our belief that the key differences between public and private environments — and thus between public and private schools — are anchored in their characteristic methods of social control.

Public schools are captives of democratic politics. They are subordinates in a hierarchic system of control in which myriad interests and actors use the rules, structures, and processes of democracy to impose their preferences on the local school. It is no accident that public schools are lacking in autonomy, that principals have difficulty leading, and that school goals are heterogeneous, unclear, and undemanding. Nor is it an accident that weak principals and tenured, unionized teachers struggle for power and hold one another in relatively low esteem. These sorts of characteristics constitute an organizational syndrome whose roots are deeply anchored in democratic control as we have come to know it.

Private schools are controlled by society too, but there are few, if any, political or administrative mechanisms to ensure that they respond as they "should." They make their own decisions about policy, organization, and personnel subject to market forces that signal how they can best pursue their own goals and prosperity. Given their substantial autonomy, it is not surprising to find that principals are stronger leaders, that they have greater control over hiring and firing, that they and the teachers they choose have greater respect for and interaction with one another, and

that teachers — without conflict or formal demands — are more integrally involved in school decision-making. As in the public sector, these sorts of organizational characteristics are bound up with one another, and they jointly arise from the surrounding environment. Different environments promote different organizational syndromes.

If this is essentially correct, the standard proposals for reforming public schools are misconceived. Reformers are quick to say, for instance, that schools should have greater autonomy or that principals should be stronger leaders, but these sorts of reforms cannot simply be imposed on schools in the public sector. In the first place, politicians and administrators have little incentive to support fundamental reform; their careers are tied to their own control over the schools, and they are unavoidably responsive to well-organized interests with stakes in the institutional status quo. To be sure, they have supported certain minor reforms. But these — such as stricter graduation requirements and tougher discipline — leave the basic structure of the system intact.

In the second place, any reform that leaves the basic structure intact will tend to be assimilated and neutralized. In general, the various components of the existing system are so strongly interconnected that any attempt to change one component in isolation will set off a series of compensating adjustments among all the others, mitigating the impact of the reform. While reformers might yearn for a maverick principal who comes on like a strong leader, for example, such a person would quickly tend to get into hot water with political and bureaucratic superiors, teachers, and unions — and find himself either looking for a new job or adopting a new leadership style.

While it may seem like heresy, the key to public school improvement may well be to break the bonds of democratic politics. If public schools are to develop the organizational qualities that most research indicates are essential for real improvements in education, it may be necessary to emulate the system of control that governs the private schools, where teaching and professional autonomy flourish. There are various ways in which this might be carried out. But in general terms, effective control over schools would be transferred from government to the market. Government would still set minimum requirements. It also would provide funding, likely in the form of vouchers allocated to parents. But virtually all the important decisions about policy, organization, and personnel would be taken out of the hands of politicians and administrators and given over to schools and their clients: the students and their parents.

In a system requiring competition for students and resources, schools would have incentives to move toward more efficient and effective forms of organization. Schools that cling to costly bureaucratic methods, that do not attract and utilize talented people, that fail to encourage collegial and productive relationships among their members, or that lack strong leadership toward clearly defined educational goals — that is, schools that look like many of today's public schools — would tend to go out of business. Effective schools would tend to prosper.

This is a reform so profound and threatening to established ideas and practices that it may not be taken very seriously. But if schools are largely products of their environments, it may be the only reform that can substantially improve their performance.

Paying for College: A Lifetime Proposition

Michael S. McPherson
and
Mary S. Skinner

DO YOU FEEL OBLIGED to pay for your child's college education at the best (read: most expensive) institution he or she can get into? Are you financially equipped to handle that obligation? More and more parents, even affluent ones, are asking themselves these questions as they watch the costs of a year's education at the most selective private colleges and universities soar toward the \$20,000 mark. At current rates of college cost inflation, it is not implausible that by the end of the decade the bill for putting two teenagers through a school like Harvard or Amherst will be \$200,000. There are very few families in our society who can take such sums out of petty cash.

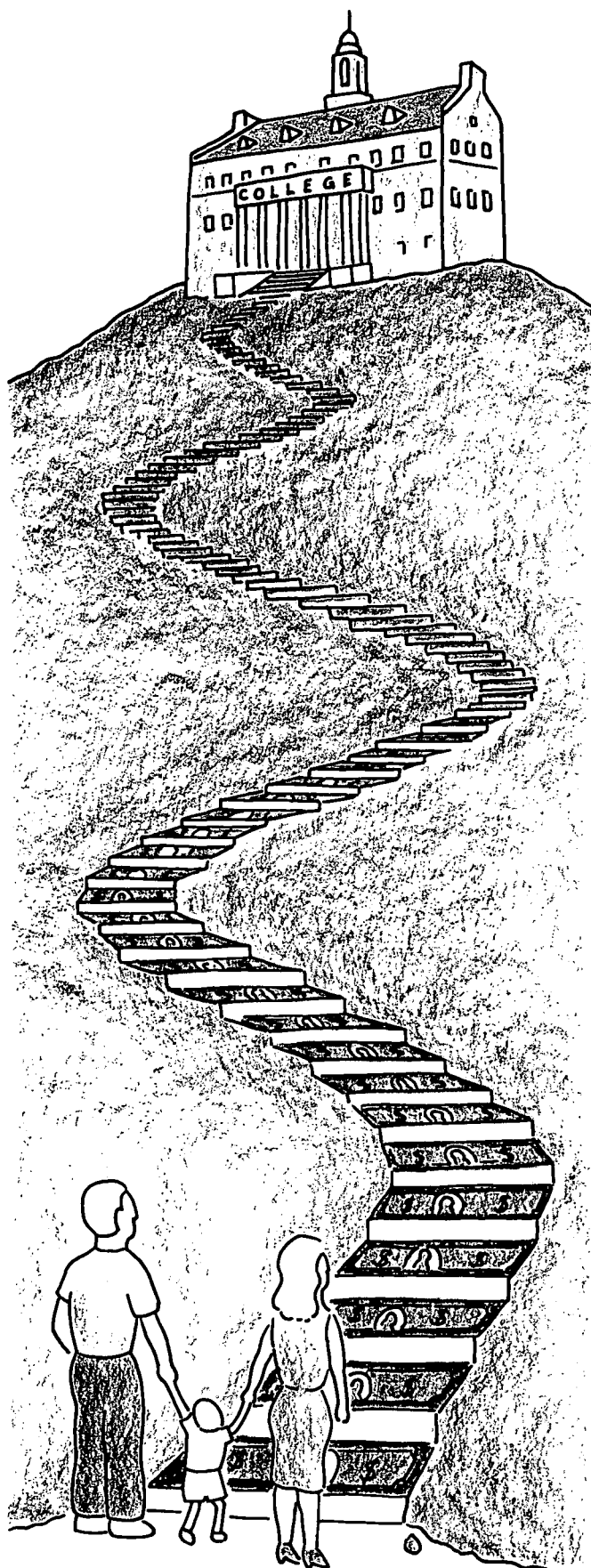
If parents are to foot such bills, they will either have to go heavily into debt — perhaps refinancing their homes — or else make careful advance plans for saving. If parents cannot or will not pay for their children's higher education, those costs will have to be shifted either onto governments, which is not very likely in this age of deficits, or onto the students themselves, in the form of greatly expanded loans. At the moment we are drifting without much thought toward expanded loan finance: Congress is about to pass legislation that raises by more than half the amount of federally guaranteed loans undergraduate college juniors and seniors can take on and allows even greater increases for graduate and professional students.

The dramatic surge in charges at elite private institutions has helped feed concern about college costs, but the underlying financing problems are much broader. The average private institution now costs families between \$40,000 and \$50,000 for four years, and educating two or three children at those prices is no easy task. Moreover, tuition charges at both public and private schools have been rising faster than family incomes throughout the 1980s. Between 1980 and 1984 average tuitions rose by 56 percent at private colleges and by 49 percent at public institutions, while family incomes rose by only 26 percent.¹

In-state public tuitions remain much more modest than private tuitions. However, the overall financing burden, while less visible, is no less real at public than at private schools. Public institutions keep the cost to families down largely through heavy state subsidization of the institutions' operating costs. Average instructional costs at four-year public and private schools are quite similar.

College is in fact a long-term investment returning financial and personal benefits that extend over a lifetime, but our society is ill-prepared, either psychologically or institutionally, to think of paying for college in lifetime terms. Surveys indicate that few parents even begin to think about saving for their children's college education until the children are well along in high school.² And the standard loans available to college students must be paid back within 10 years after they leave school — even though the returns on the investment in education are spread over the rest of their lives.

*Michael S. McPherson was a senior fellow in the Economic Studies program at Brookings, on leave from Williams College, when he co-authored this article. He returned to Williams this fall to chair the economics department. McPherson is the author of *The Ends and Means of Student Aid* (forthcoming). Mary S. Skinner is a research assistant in the Economic Studies program. The authors wish to thank Terry Hartle, Robert Reischauer, and Alice Rivlin for helpful comments on an early draft.*



Perhaps most strikingly, the formulas both colleges and the federal government use in determining a family's "need" for student assistance are utterly oblivious to the issue of financing over time. All the financial aid forms ask for is the family's financial condition in the year it applied for aid: a profligate who has blown a six-figure income every year for a decade and has finally landed on unemployment is treated better than a working-class family that has painfully accumulated a college saving fund over the decades. A family whose two children attend college at the same time is treated much better than one who pays for two children one after the other. At the other end of the time line, a student who has been awarded a federally guaranteed loan continues to benefit from subsidized interest even if she becomes a bank president at age twenty-five.

The question we need to ask is: What financial arrangements make sense in a world where most people will spend a substantial fraction of their lives paying for *somebody's* college education — whether their own, their children's, or (as taxpayers) the public's at large? As a society we need to address these questions to help clarify families' understanding of the obligations parents have toward children's education and the obligations children have for their own. Sorting out these issues can also provide the basis for reassessing government's obligations, both toward families who, in a lifetime sense, need financial aid to help pay for college and toward those who only need help in arranging the financing of their college payments.

The Current Financing Picture

Before examining how college *should* be paid for, it is helpful to review briefly past trends and future prospects for college costs and financing. Today families pay about a third of the total instructional and living costs of students, state governments pick up about another third (mostly through operating subsidies to public institutions), and the federal government and philanthropy share the last third about equally.³

Back in the 1930s families paid two-thirds of the total instructional bill (including living costs).⁴ The declining share of costs borne by families since then has been matched by an expanding role for governments (see figure 1). State expenditures on higher education have grown rapidly as the share of enrollments in state-run institutions has gone from 50 percent in the 1930s to over 75 percent now.⁵ And the federal government has paid a growing share of the tuition charges in public and private institutions through its student assistance programs — both the several GI Bills and the grants and subsidized loans provided through the Office (more recently Department) of Education.

Over the last 50 years, the instructional costs of colleges and universities have grown between 2 and 2.5 percent a year above inflation, roughly keeping pace with the growth in family real incomes. With an expanding role for government, however, the per-student tuition and living costs directly facing families have actually grown somewhat less rapidly than average family incomes (though still faster than inflation). This shifting of the financing burden toward government helped make it possible for more families of modest means to send their children to college and for families to send more of their

children (especially their daughters) on to higher education. From the mid-1950s to the end of the 1970s, college enrollments per 100 persons aged 18 to 24 rose from 18 percent to 36 percent.⁶

What will the next 20 years look like? The costs of higher education will probably continue to grow. The basic technology of education remains — as it has since Aristotle's day — an instructor talking with a couple of dozen students. And since, in the long run, the salaries of those instructors have to keep pace with wage and productivity growth elsewhere in the economy, rising unit costs in education seem inescapable. The exception proves the rule: higher education kept growth in operating costs and tuition charges at or below the rate of general cost inflation in the 1970s only by reducing real faculty salaries by more than 20 percent. This is not a performance schools can repeat in most decades.

Although growth in college operating costs will outpace inflation, those costs are not likely to run ahead of growth in national income or in average family incomes. The nation will continue to be able to afford its higher education bill. But over the next 20 years families are not likely to find governments assuming a rising share of the total bill, as they did during the last 30 years. Both state and federal governments are feeling the pressure of other fiscal commitments. They may well — and probably should — ask

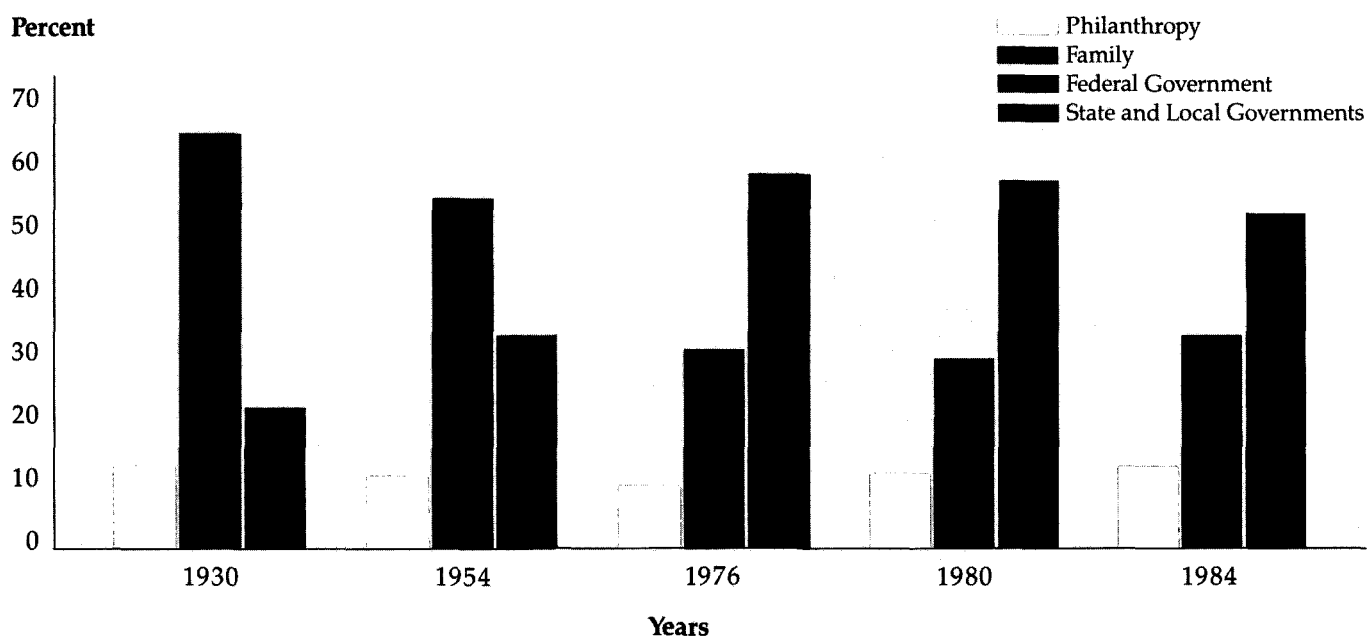
those families who can afford to pay college costs to shoulder a larger share of the burden through increased tuition charges, focusing government education subsidies on those who genuinely need financial help.

Such a trend would be bound to produce a searching reassessment of issues about who can pay for college and how such payment should be divided between parents and students. The current worries about paying for college may mark the beginning of that reassessment. Instructional costs have resumed their long-term rise, as colleges have reversed the 1970s pattern of reducing the real salaries of faculty.

At the same time, the 1980s have seen a sharp reversal of the trend for growing government support of education, as the federal share of instructional costs has dropped from 21 percent to 15 percent. And much of the remaining federal help has been shifted from grants to greatly expanded loan support, with the result that federal student loans now total more than half the tuition bill facing families.⁷

Students do not repay the full value of these loans — parents pay off some of the loans, and much of their value is paid for by federal interest subsidies. But clearly the rapid rise in student loans and the unusually steep tuition increases of the 1980s are focusing new attention on the size and distribution of the burden of paying for college.

Figure 1. Who Pays for College: A Historical Perspective



Note: Educational costs are figured as the instructional revenues of institutions (excluding research funds) plus the living costs of students. Government support includes grants to institutions (excluding research), student aid grants, and the subsidy value of student loans. Family shares are figured as tuition expenses less student aid, plus an estimate of living costs of students based on average room and board charges. Philanthropy includes all other sources such as income from endowments and private gifts.

Sources: For 1930, The Carnegie Council on Policy Studies in Higher Education, *Next Steps for the 1980s in Student Financial Aid: A Fourth Alternative* (San Francisco: Jossey-Bass Inc., Publishers, 1979), p. 141. For 1954, instructional revenues are calculated from figures on pp. 20-21, 29 of June A. O'Neill, *Sources of Funds to Colleges and Universities* (Berkeley: The Carnegie Commission on Higher Education, 1973). Living costs are authors' estimates. For later years, data are authors' calculations based on HEGIS (Higher Education General Information Survey) statistics and other student aid data.

The Chain of Generations

As the costs as well as the benefits of college education come to be spread over more of people's lifetimes, we shall need to learn to think about college financing in more explicit intergenerational terms. Just as we are coming to view issues about pensions and social security, federal budget deficits, and long-term health care for the elderly through the lens of appropriate sharing of burdens among successive generations, so should we bring that sort of framework to bear on higher education finance.

The aging process introduces a helpful symmetry into intergenerational reasoning. The politics and economics of social security, for example, are shaped fundamentally by the fact that people grow old. In a similar way, our thinking about college finance should be shaped by the knowledge that every parent was once a child and most children will someday be parents. Given the right kinds of institutions for saving and borrowing, a stable system of family finance of higher education can then be run by having each generation pay either for its own education or for that of the successor generation (or some combination).

This is true, anyway, subject to one important caveat: the arrangement of having each generation pay for its successor works only so long as every generation honors the implicit agreement to perpetuate the chain. Any one generation can get off scot-free by accepting its parents' largesse and refusing to help its own children. This caveat raises two points. One is that if, at any time, a society wishes to move in the direction of having children pay for more of their own education through student loans — as ours is seeming to do — there is an awkward problem of managing the transition fairly.

The second point is that, in any society that wants to sustain a pattern of intergenerational transfers, the decisions about making those transfers cannot be viewed as purely private ones. Governmental coercion need not be involved, but social norms and expectations that encourage members of each generation to uphold the terms of the generational compact will be needed. This point applies not just to higher education but to budget deficits, old-age pensions, child care, and other intergenerational issues as well.

We shall return to these points later. For now, consider yourself as one link in the chain of generations and ask two questions: Would you prefer to pay for your own or for your children's education — and *when* in your life would you prefer to pay for it?

Whatever the answers, one sees immediately that shifting the "hot potato" of college finance among generations does not make it disappear. Some commentators seem to think that getting parents to save will relieve the student generation of the burden of paying off loans. Well, sure it will, but only at the expense of loading the student generation with an obligation to save for *its* children's education. Similarly, shifting the burden forward to students relieves the present generation of parents, but no future generation: freed of paying for their children, future generations will instead be paying off their own debts.

If the financial implications of student versus parental finance are largely a wash in the long run, the educational implications may not be.⁸ Students may well weigh their options differently if they know *they* are going to have to foot the bill for their college education for the next 10 to 20

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years. Tell an 18-year-old high-school graduate that she is going to be responsible for \$70,000 for a Princeton education and she may decide that her in-state public university looks like a better deal. Her parents, however, who may have received the benefits of higher education or at least appreciate what such an education could have done for them, may value high-quality education much more than the 18-year-old who is weighing the unknown benefits of higher education against seemingly staggering amounts of debt.

The case of a Princeton student is, of course, an extreme example: most students do not even consider going to Princeton, and arguably, some might be better off considering the costs of such an education a little more seriously. Yet the point holds equally for a student weighing the costs and benefits of a one- or two-year vocational education versus a broader four-year education. Parental “grants” to finance part of the cost of higher education may give students more freedom to experiment with new ideas and to develop a taste for learning for its own sake than they would allow themselves under a student-loan-financed system. Considerations like these must be weighed against the obvious advantages of centering the financial burden of paying for college on students who reap its main benefits.

It is clear that, if the financing burden on families does continue to rise, we as a nation will need to sort through how we want these burdens shared. Families will no doubt continue to have considerable leeway to work out their own solutions, but the kinds of norms and expectations we encourage through public discussion and the kinds of institutions we develop to manage financing will shape the terms of the generational compact.

No matter whether future burdens are directed mainly to parents or to students (or, for that matter, to governments), existing financing structures are clearly too weak to handle them. And because any plausible resolution of the financing issues is likely to require continued partnership on some terms among parents, students, and government in paying for college, it is useful to explore options for all three here.

In the following pages, we distinguish broadly those parents and students who have the resources, in a lifetime sense, to pay for college from those who, even with help in

borrowing and saving, would still be "needy." For the first group of parents and students we discuss the kinds of arrangements, both privately and publicly supported, that could help them manage their finances. We then discuss how the notion of "helping the needy" should be rethought in a world where paying for college is a lifetime proposition.

Helping Students Pay

Students help pay for college by working while in school and saving up from jobs they hold in high school. But the potential for pushing this line of financing much further is limited, given low student wage rates and the fact that a majority of college students already work summers and part-time during the school year.⁹ The only realistic way for students to assume more of their college costs is to borrow and pay back through their future earnings. And the main obstacle to that, as economists have long known, is the difficulty students encounter in using future earnings as loan security: a lender can repossess a car but not an education.

Currently the nation's main vehicle for overcoming this capital market imperfection is the federal Guaranteed Student Loan (GSL) program, which fully ensures banks against loss on loans they make to students under its provisions. But the program awkwardly blends this loan insurance feature with the quite different goal of subsidizing students' interest costs. The government pays all interest costs while a borrower is in school and after that pays the lender a "special allowance" that is supposed to reflect the difference between the lender's cost of making the loan and the fixed interest rate paid by the student.

The tension between these goals was brought out clearly in the late 1970s, when Congress made all students eligible to borrow GSLs without regard to income. As it happened, this "uncapping" came at a time when the gap between market interest rates and the legislatively set GSL fixed interest rate was at an all-time high. The result was that everybody who could count borrowed the limit in GSLs: one could in fact make a tidy profit investing the proceeds of a GSL in the money market.

Congress responded to the resulting explosion in federal costs by reintroducing means tests for GSLs. Ironically, this move to guard the budget only ensures that the loans will go to students who need *subsidies*. Students whose affluent parents refuse to secure their loans may still need help in gaining access to the credit market, but they are denied that access for the irrelevant reason that they do not need subsidies.

The sensible course would be to reduce federal interest subsidies sharply while making insured loans more widely available. Subsidies, where they are warranted, should be provided in the form of more visible and accountable grants. But would the burden of repaying unsubsidized loans be too much for students to handle? The amount of subsidy borrowers receive fluctuates widely with interest rates (another unappetizing feature of the present program), but, on average, students pay back only about half the value of their borrowings.

Most students probably could handle the doubled burden if repayment schedules were better calibrated with the timing of the returns on the educational investments they finance. Currently students typically must repay their loans in equal installments during the 10 years after they

complete schooling. But most students do relatively poorly in the labor market in the first few years out of school, reaping much of their return on education long after 10 years have passed. It would make sense to extend repayments to 25 years or even longer, making the loans more like mortgages, and to provide graduated repayment schedules, with smaller payments in the immediate post-schooling years.¹⁰

Although these more flexible repayment terms would help the average borrower, they might still impose hardship on students whose career plans worked out badly or who chose relatively low-paying careers such as teaching. In fact, heavy dependence on loan finance might turn students away from choosing lower-paying but personally and socially rewarding careers. Long-term student loans ought then to include some form of low-income insurance.

The ambitious way to provide such insurance is to make everyone's loan repayments a function of income, setting the income-repayment schedule so that the lending authority can expect to earn a fair return on the whole.¹¹ Elegant but administratively rather cumbersome schemes to this effect have been advanced many times in the last 20 years. A simpler approach, which would capture many of the benefits of the more elaborate schemes, would allow borrowers with low incomes to apply for reduced payments. The difference necessary to provide a fair return to the lender could be financed out of an insurance fund supported by charges on borrowers. Such a fund, as we note below, might be an attractive vehicle for federal subsidy.

Helping Parents Pay

Middle-class parents do not face the same capital market problems students do. By middle age, most families have substantial net worth, often in the form of home equity, against which they can borrow at fair market rates. The problems they do face (putting aside poor and needy families) are of two kinds.

First, they need help with orderly planning of college expenses. A good analogy is the home mortgage — a financial instrument that not only spreads payment over a manageable length of time but also provides families with a framework for thinking through the task of becoming home-owners. The familiar mortgage formulas help guide families in figuring out how much house they can afford, what advance preparation they need, and how they can manage the debt over time. Nothing comparable exists in college finance.

Second, families who contemplate saving for college would like to reduce their uncertainty about future college costs. Especially when coupled with uncertainty about their children's educational needs and aptitudes, coming up with a rational saving plan is a daunting task.

A number of colleges are now allowing prepayment of all four years of tuition at freshman rates at the time of initial enrollment, and some are developing lending arrangements through local banks or consortial arrangements to finance the prepayment with long-term loans. Such borrowing options are attractive to parents because they avoid uncertainties about cost growth and children's educational needs. They also improve cash flow for colleges and (pending revised treatment of consumer interest under tax reform) provide substantial tax deductions.

Borrowing arrangements are ideal for parents who want to bear the costs of college late in life, after the years of home-buying, child-raising, and career-developing are behind them. At that point, loan repayments compete mainly with retirement saving as uses of discretionary funds.

Given existing tax law, even parents with substantial savings will find it advantageous to borrow against assets instead of drawing on them to pay for college. But the considerable interest in specialized financial instruments for college saving suggests that many parents would prefer to put money aside for their children's education in advance, despite the competing claims on savings in those years. If the pending tax-reform legislation eliminates deductibility of interest on consumer loans, the already growing interest in college savings plans is likely to increase. A number of proposals for federally subsidized "educational savings accounts," modeled more or less on the popular individual retirement accounts, have been put before Congress, but their momentum has been blocked by the tax-reform movement.

The action instead has shifted to "education futures" plans being developed by schools and states. These plans would allow parents to guard against inflation by paying for their children's education in installments many years before college entrance. States or colleges would invest these funds in hopes of earning a return that would cover the future cost of the education. With luck and some favorable Treasury rulings, the implicit return on the parents' investment might also escape tax, upping the net returns substantially. Education futures plans instituted by Duquesne University in Pittsburgh and proposed for Michigan's public colleges by Governor James J. Blanchard have already received a great deal of publicity.

Parents clearly like both the hedge against college cost inflation and the potential tax break these plans offer. The least attractive feature of these plans, however, is that they force parents to predetermine their children's college choices.¹² In the Duquesne plan, for example, a student who is accepted by the university must enroll there for at least a year or forfeit the entire parental investment. The parents of a student who is denied admission at Duquesne get their money back — the original investment, that is, with no interest. Although the Michigan plan is not finalized, some of its versions would inflict similarly harsh penalties on the parents of students who decide ultimately to enroll out of state.¹³

Restrictions like these are probably enough to drive such plans out of the marketplace. Certainly, from a public policy viewpoint, such restrictive plans ought not to be welcomed, for their proliferation would encourage a terrible balkanization of higher education and — with college commitments made so far in advance — would produce widespread mismatches between student preferences and college destinations.

One way to preserve the cost-hedging feature of these plans while avoiding the pernicious side effects on college choice would be to set up a savings fund indexed to college tuitions. A consortium of schools with diverse offerings and admissions criteria might agree to sell shares in a "market basket" of their future tuitions — one share might equal 10 percent of the average tuition of the market basket. Investors would be guaranteed that a share would keep its value, much like the Consumer Price Index futures now

being sold on the commodities exchanges. Parents who bought four shares a year for 10 years would have prepaid the average college tuition of the market-basket schools.¹⁴ Parents would be protected against inflation in the average cost of college — although not against rises in the relative price of the particular school they eventually selected. And, if the market basket was well designed, parents would have succeeded in preserving an adequate range of college choice.

Whether anybody could expect to make a profit selling shares in such a fund depends essentially on the premium parents are willing to pay for a college inflation hedge. Groups of colleges might be interested in backing such a fund because it would help to ensure their future market and stabilize their cash flow. But an index scheme could probably work only if it received some form of subsidy from the federal government.

There are two possible rationales to justify such a subsidy.¹⁵ First, if prepayment plans for individual schools and states gain popularity and favorable tax treatment, subsidizing index plans would clearly be warranted as a way of averting balkanization. The second possible justification relates to the issue of the generational compact. If, as a society, we collectively prefer to keep a large parental role in paying for college, then we need to create a social environment that encourages and reinforces the norm of parents accepting that responsibility. Subsidized college saving plans are one (though certainly not the only) vehicle for expressing social support for such parental responsibility.

Helping the Needy

Savings plans are fine for parents who can accumulate assets, and borrowing arrangements are fine for students and parents with healthy income prospects. But what about families who lack the resources, not just currently but over their lifetimes, to pay college costs? Since the mid-1960s the federal government has recognized an obligation to see that students are not excluded from college, and do not have their college options unduly restricted, because their families are unable to pay. Many colleges have also used their own resources to bring their costs within reach of students who otherwise could not attend. Available programs, however, do not adequately take account of the distinction between parents' needs and students' needs. And they are based on the unrealistic assumption that college costs are paid for exclusively out of current income.

Parental ability to pay would not matter so much if our higher-education financing system — both its institutional structure and the norms it rests on — were based consistently on the assumption that students should pay for their own education. Long-term loans with income insurance could permit students to handle the load, and family background could, at least in principle, be largely ignored in determining how students would pay for college.¹⁶ In fact, however, most students from affluent families can confidently expect substantial parental help in paying for college. Is it fair, then, to expect students from poor families to shoulder the load themselves, especially since existing loan repayment schemes do not give them much flexibility?

The basic strategies of both federally and institutionally financed grant programs are a sensible response to this inequity. They try to determine how much a student's family

is able to contribute and then fill with grants the gap between the parental contribution and the amount of assistance the student needs. Budget limitations mean that the gap is often not filled completely, but the available money can be targeted fairly effectively by this approach.

There is, however, a crucial gap in the logic by which the parents' ability to pay is determined. The existing needs-analysis systems determine the parents' financing capacity by looking only at their income, expenses, and assets in the preceding year.¹⁷ But a family's financial capacity is really determined by its *lifetime* earnings and financial obligations. The underlying principle of parental responsibility is violated if parents who could save and didn't are treated the same as those who never had the opportunity. These nuances may not matter much for the poor and nearly poor people who currently qualify for Pell grants, the major federal student grant program. But at the more expensive private institutions, where families with incomes above \$50,000 a year sometimes qualify for institutionally financed grants, the differences between current and lifetime income and the opportunities for financial shenanigans may be quite significant.

Finding practicable ways to approximate measures of past and future incomes and assets is a formidable challenge but one that the financial-aid community needs to come to grips with. One widely discussed approach to widening the temporal window of needs analysis is to compute an expected amount families should have saved for college, based on occupation, work history, and present income. Parents who failed to meet the savings expectation would have to borrow to make up the difference, rather than receive grant aid. This and other possible devices would make clear that people should plan to pay for college expenses over time.¹⁸

What about student need? The difficulty here is that most full-time students will appear quite needy in terms of current income but can expect, on average, to do quite well in terms of lifetime income. The existing needs-analysis systems in fact view "emancipated" students, those who no longer depend on their parents for financial support, in light of their current, usually temporary, poverty, thus incidentally creating a considerable incentive for parents to contrive to make their children (either in reality or appearance) independent.

Surely a more sensible view is that suggested by the discussion of long-term loans above. Since typical students are not poor in any long-term sense, what they deserve is not subsidies but access to credit on reasonable terms. To be sure, some of these students will earn less than average and turn out to be, if not poor, at least heavily burdened by loan repayments. These students are, in the relevant lifetime sense, needy and deserve the kind of help provided by reduced payments on their loans. Federal contributions to the insurance funds that make those payments seem a highly attractive way of targeting subsidy dollars.

Conclusion

The United States has the capacity to fashion a system for financing higher education that should work well into the twenty-first century. But putting that system into place will require considerable forethought and national discussion; it

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will also require a recognition that our current policy of drift has several drawbacks.

First, and most immediately, the GSL program is a fragile foundation on which to rest our student-lending arrangements. The program was never designed to be a major vehicle for financing higher education, as its eligibility requirements (necessitated by the large subsidies the loans embody) and rigid repayment requirements make clear. Moreover, the structure of the GSL interest-rate subsidies exposes the federal government to enormous inflation risk. Because both lenders and borrowers are fully insured against rising interest rates under GSL, every percentage point rise in the Treasury bill rate costs the federal government almost \$500 million in added subsidy payments. When the amount of outstanding debt under GSL doubles — as it could in fairly short order with the higher loan limits Congress is expected to authorize this year — the cost will rise toward \$1 billion a point. A return to double-digit inflation under those circumstances would be a budgetary calamity that could do lasting damage to the whole student-aid system.

Second, the emerging efforts of states and colleges to help families cope with financing problems have pitfalls and limits too. It is important from a national viewpoint to work for arrangements that do not restrict students' choice of college to one school or even to the schools of one state. Moreover, all the emerging plans aim to help families who, in the long run, possess the resources to pay for college.¹⁹ The federal government needs to play a lead role, along with states and institutions, in ensuring that disadvantaged students are not denied a fair opportunity for college.

Finally, as individual families and as a nation, we need to face up to the generational question. We should not allow ourselves to drift toward having students pay for their own education through loans without asking ourselves some hard questions about our motives. Is this the arrangement that we really think in the long run is the best way to pay for education (as we might well conclude)? Even if it is, are we handling the transition from parent to student payment fairly? Should the same generation that is bequeathing its children an extra \$1 trillion in national debt hand its offspring a bill of upwards of \$25 billion a year for their own college educations?

1. Calculated from Census data on family income reported in The College Board, *Trends in Student Aid: 1980–86* (New York: The College Board, 1986), p. 10, and college cost data reported in National Center for Education Statistics, *Digest of Education Statistics, 1983–84* (U. S. Government Printing Office, 1985), p. 141.

2. See Roper Organization, Inc., *National Study on Parental Saving for Children's Higher Education* (Washington, D.C.: National Institute for Independent Higher Education, August 1984).

3. Authors' estimates based on data from the U. S. government's Higher Education General Information Survey and other student-aid data.

4. Carnegie Council on Policy Studies in Higher Education, *Next Steps for the 1980s in Student Financial Aid: A Fourth Alternative* (San Francisco: Jossey-Bass, Inc., Publishers, 1979), p. 141.

5. Enrollment figures for 1930 are from June A. O'Neill, *Resource Use in Higher Education: Trends in Output and Inputs, 1930 to 1967* (Berkeley: The Carnegie Commission on Higher Education, 1973), p. 71. Figures for 1980 were calculated from *Digest*, op. cit., p. 94.

6. Calculated from data in U. S. Bureau of the Census, *Current Population Reports*, Series P-20, No. 360 (October 1979), p. 7, and

No. 66 (October 1955), p. 9.

7. Authors' estimates based on data from the U. S. government's Higher Education General Information Survey and other student-aid data.

8. There is not room here for a more detailed assessment of the financial implications. In a society with large families, for instance, the typical parent would want to see the burden shifted forward, but as our population growth approaches replacement levels, this issue drops away. Parental savers receive interest, while student borrowers pay. But student borrowers incur their educational costs about 20 years earlier, and so get a saving on college cost inflation that may roughly match their interest costs.

9. See Pamela Christoffel, *Working Your Way Through College: A New Look at an Old Idea* (The College Board Washington Office, 1985).

10. Congress, as of Sept. 1, was considering legislation that would lengthen repayment periods and permit graduated payments for students with large outstanding loan obligations. Obviously, students could be allowed to repay their loans early, and some would be likely to do so if interest rates were unsubsidized. (Subsidized interest gives students an incentive to extend the repayment period as long as possible.) The proper tax treatment of such loans is an interesting question. Under current law, interest would be deductible as is other "consumer" interest. This deduction might be eliminated under tax reform. But a case could be made that these loans really represent borrowing against (human) investment income. For a discussion of the pros and cons of such treatment, see Henry Aaron and Harvey Galper, *Assessing Tax Reform* (Brookings Institution, 1985), pp. 76–77.

11. Milton Friedman first proposed such a scheme in 1955. Yale University experimented with an income-contingent loan plan in the mid-1970s.

12. If the Treasury Department judges these plans to be binding prepayment contracts, then the return would not be subject to tax. But if they are investments, then they are taxable. The more firmly the plans lock the family into a predetermined college option, the more likely they are to be viewed as contracts but the less attractive they are from the point of view of parents and of public policy.

13. Descriptions of the Duquesne and Michigan plans are drawn from "Capital Ideas: A Newsletter of the National Forum for College Financing Alternatives," Vol. 1, No. 1 (June 1, 1986).

14. If the school parents selected were more expensive than the market-basket average, they would pay a premium; if it were cheaper, they would receive a rebate.

15. A tax subsidy is the first option that comes to mind. But, if a subsidy is justified at all, it is likely that some form of direct subsidy would be more efficient and equitable than a tax subsidy.

16. We say "in principle" loans could handle the load because there is evidence that in fact students from disadvantaged backgrounds are reluctant to borrow heavily for education, partly because their families have little experience with long-term credit (and the experience is often negative). Moreover, students from poor families often have to contribute something to support the family, so that their need for financial assistance may exceed their costs of college. These special needs might require attention even in a financing system that otherwise ignored parental resources.

17. That this position is not simply a matter of convenience in measurement but a matter of principle is shown in the following quotation from the manual provided to financial aid officers by the largest needs-analysis service: "...students and their families must be accepted in their present financial condition. . . . [The needs-analysis system] cannot distinguish between the frugal poor and the spendthrift. It cannot distinguish between improvidence and financial hardship."

18. Karl E. Case and Michael S. McPherson, *Does Need-Based Student Aid Discourage Saving for College?* (The College Board Washington Office, 1985).

19. See Terry Hartle, "That Tuition Bill," *Washington Post*, August 5, 1986.

A Case for International Coordination of Monetary Policy

Gerald Holtham

OVER THE PAST five years the U.S. economy has become seriously out of balance. The federal budget deficit equals nearly 5 percent of gross national product in 1986; the associated deficit in the balance of payments current account is over 3 percent of GNP. The United States, which became a net debtor country in 1985, is on the way to becoming the world's biggest debtor. Borrowing from foreigners to finance the twin deficits is at interest rates higher than the growth rate of nominal GNP, an unsustainable situation. Meanwhile economic growth in the United States has fallen to little more than 2 percent a year.

The Reagan administration believes that the Europeans and Japanese could ease the United States' economic problems by stimulating their own domestic demand growth. Hence the public exhortations by both Treasury Secretary James A. Baker III and Federal Reserve Chairman Paul Volcker to other countries to change policies.

Generally, since September 1985 when the five largest Western economies agreed to cooperate to lower dollar exchange rates, Secretary Baker has been a vigorous promoter of international cooperation. His efforts appeared to bear some fruit at the end of the Tokyo economic summit last May when the heads of state of the same five countries agreed to seek closer cooperation. Subsequent practical measures, however, have not been forthcoming. The second and third largest Western economies, Japan and West Germany, are resisting Baker's arguments for stimulatory policies.

There is a very strong case for a measure of international coordination of monetary policy, as will be argued below. But actions by other countries cannot substitute for determined policy action by the United States. In the absence of a substantial reduction in the U.S. budget deficit, no policies that foreign economies are likely to undertake would have more than a marginal impact on U.S. growth and trade. Therefore, the prospects for longer-run cooperation should not be sacrificed to an attempt to get other countries to bail out the United States through an immediate stimulus.

U.S. Imbalances: Can Foreigners Help?

What would be the impact on the U.S. economic outlook if other member countries of the Organization for Economic Cooperation and Development (OECD) were willing to adopt policies to increase their domestic demand? A recent conference hosted by the Brookings Institution assembled simulation results from a dozen international econometric models bearing on this and related questions. One conclusion that emerged is that the type of expansion matters; foreign fiscal and monetary policies have quite different effects on the United States.

Gerald Holtham is a visiting fellow in the Economic Studies program at Brookings where he is working on international macroeconomic coordination. Holtham is a former head of the general economics division in the economics and statistics department of the OECD Secretariat in Paris.

Fiscal Effects

Substantial consensus existed among the models about the short- and medium-term effects of fiscal policy. Model results, backed up by an examination of trade shares and patterns, suggest the following. If all OECD countries except the United States somehow increased their GNP by 1 percent and if exchange rates stayed the same, the resulting boost to U.S. exports could raise U.S. GNP by about a fifteenth of a percent in the first year. A fiscal expansion in foreign countries equivalent to 1 percent of their GNP would increase their GNP by a little more due to the multiplier effect. It would also tend to push up foreign interest rates and so depreciate the U.S. dollar, raising the first-year effect on U.S. GNP to perhaps a quarter of a percentage point. That effect would decay over time, roughly halving over three years. If countries with chronic public deficits, like Italy, abstained, leaving the stimulus to a few countries like Japan and Germany, the effect on the United States would be even smaller.

This level of stimulation, while marginally useful, would not decisively alter U.S. growth prospects. Nor would fiscal action have a great impact on the U.S. external deficit. The model simulations suggest that a fiscal boost in the rest of the OECD nations equal to 1 percent of their GNP would improve the U.S. current account balance by something in the range of \$3 billion to \$12 billion after two to three years. (The average result was about \$6.5 billion.) The current account deficit in the first half of 1986 ran at an annual rate of around \$130 billion.

In 1983–84, when the United States acted as a “locomotive” to the world economy, its domestic demand grew at an annual rate of over 8 percent. To generate a comparable stimulus for the world economy, Japan, Germany, and France, given the smaller size of their economies individually, would all need to expand their domestic demand together at an annual rate of 8–10 percent. Action on any such scale is beyond the bounds of political feasibility.

Monetary Effects

Without corresponding action on the part of the Federal Reserve, a monetary relaxation abroad might not help the United States at all. The reason is this. A fiscal expansion, by increasing the demand for credit and thus raising interest rates, can appreciate the currency of the country taking fiscal action, which in turn attracts imports and spreads some of the stimulus abroad. But a monetary expansion tends to lower interest rates, thereby depreciating the currency and helping to bottle up the expansion at home. In short, the United States might lose more from the resulting appreciation of the dollar than it would gain from the greater domestic demand in these nations that decided to

undertake a monetary expansion.

Considerable diversity about the effects of monetary expansion in other OECD countries existed among the models represented at the Brookings conference. Some had positive spillovers on U.S. GNP and the current account balance; others were negative. Net effects, however, were usually small. Given the current state of knowledge, it is reasonable to conclude that there is little or no direct effect on, certainly no substantial direct benefit to, the United States from monetary expansion abroad.

To reduce the U.S. trade deficit, therefore, there is no alternative to policy action in the United States. In particular, substantial cuts in the federal deficit would restore the national savings/investment balance, further reduce real interest rates, and promote further depreciation of the dollar.

However, U.S. budgetary action would have other significant consequences at home and abroad.

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Domestic Effects of U.S. Deficit Cuts

The depreciation of the dollar that has already occurred is expected to improve the U.S. trade balance in the months ahead. That and the fall in oil prices, which will leave extra money in consumers’ pockets in all industrialized countries, are expected to quicken U.S. growth late this year and early next—despite an assumed domestic fiscal contraction due to deficit reduction. By mid-1986 there were few signs that this acceleration had begun. Yet more problematic is what will happen late in 1987 and into 1988 if the boost from oil prices fades while successive rounds of retrenchment in the fed-

eral budget remain to come.

Long-term U.S. interest rates and the dollar both declined in 1985, apparently because the market believed that Congress and the administration would find some way to get control of the federal deficit. If congressional action continues to reinforce market belief that the deficit will be reduced, long-term interest rates could fall further in anticipation of reduced federal credit demands and lower growth rates. Lower interest rates would help to support economic activity. So would further depreciation of the dollar and the improved net exports it would bring. The historical record is fairly clear, however, that those automatic stabilizing mechanisms would not entirely cancel the short-term contractionary effects of government spending cuts or tax increases. (In the longer run lower deficits should foster growth through lower interest rates and a higher share of productive investment in GNP.)

What would be the effect on U.S. GNP if Congress made a cut in U.S. government expenditures equal to 1 percent of GNP and the Federal Reserve did not take specific action to counteract that fiscal contraction?¹ Averaging the available econometric model results yields a predicted reduction in GNP of 1¼ percent in the first year after the reduction. The

economy's self-correcting properties slowly remove this effect. But after three years, GNP would still be almost 1 percent below what it would have been without the fiscal contraction. Many models simulate substantial effects persisting for six years.²

Suppose Congress wants to hit Gramm-Rudman-Hollings targets and assumes the economy will grow at 3½ percent a year to 1990. That supposition implies a fiscal policy of reducing government expenditures (or raising taxes) by 2½ percent of GNP over 1987–89. However, without offsetting action by the Federal Reserve, such cuts could reduce economic activity substantially. GNP could be about 1¾ percent below the 3½ percent growth path in 1987, some 2¾ percent below in 1988, and perhaps 2¼ percent below in 1989. If monetary policy and other factors could not keep GNP growing at 3½ percent a year in the face of such contractionary impulses, the Gramm-Rudman-Hollings targets could not be met. Still larger spending cuts would be needed. If they were made, still slower growth would be inevitable.

Using monetary policy to offset fiscal retrenchment is a very delicate operation. The effects of monetary policy are more uncertain, and the lags before they are realized may be longer than the lags for fiscal policy. This conclusion is supported by the simulations presented to the Brookings conference. There was much less agreement among participating international econometric models about the effects of monetary policy than about those of fiscal policy.

Because of uncertainty and possibly long lags, it would be easy to underestimate the eventual effects of monetary policy when faced with the evidence of modest short-run impacts. The monetary policy stimulus necessary to offset a fiscal contraction in the short run could cause inflation later. Fearing this longer-run outcome, markets may become nervous at a vigorous monetary stimulus, triggering a run on the dollar, which itself would lead to accelerating inflation. This outcome has been predicted regularly ever since the Federal Reserve relaxed policy somewhat in 1982. The inflation has yet to happen, but Volcker's reticence about the necessity for further declines in the dollar probably reflects his awareness of the risk.

Foreign Consequences of U.S. Deficit Cuts

The economic recovery of Europe and Japan from the 1982 recession occurred largely because the United States proved to be a ready market for their exports. If the United States moves into recession in 1988, can they avoid recessions of their own without changing policies?

If only the direct linkages through trade are examined, it appears that the answer is yes. European and Japanese prospects, however, would be bleak enough. And that is without taking into account the developing countries' debt crisis, which is aggravated by any substantial slowing down in the growth of the industrialized countries and so threatens to magnify the deleterious effects of any such slowdown.

Consider again the simulated effects of a U.S. fiscal contraction equal to 1 percent of U.S. GNP. According to an average of model results, the impact on the rest of the OECD countries was estimated to be about a quarter of a percent of GNP in the first year, rising to four-tenths of a

percent in the third year. So if the Gramm-Rudman-Hollings targets were reached, the effect in the rest of the OECD countries might be to reduce their GNP by around a third of a percent in 1987, by more than half a percent in 1988, and by nearly 1 percent in 1989. The effect might well grow for some years thereafter.

Even if the United States succeeded in offsetting the contractionary effect of its fiscal policy by a monetary expansion, so avoiding domestic recession, its action would be unlikely to help other countries. That is because of the asymmetry, already noted, in the foreign spillover effects of monetary and fiscal policies. The fiscal contraction would hurt activity in the rest of the world, while an offsetting monetary expansion might not help, as it would depreciate the dollar still more.

On balance, then, growth in the rest of the OECD in the next few years could be a quarter to a half a percent slower because of U.S. deficit reduction. The effect on countries like Japan and Canada, which are particularly dependent on U.S. markets, would be greater; the impact on most European countries would be somewhat less. These numbers are not large, especially when the uncertainties surrounding the estimate are taken into account, but they would be bad news to economies already growing slowly with high and steady unemployment. Nor do they take account of financial turbulence that could be induced if slower OECD growth aggravates the Latin American debt crisis.

Foreign Growth: Already Too Slow

Between the cyclical peaks of 1973 and 1979, the two largest European economies, Germany and France, grew at annual rates of 2⅓ percent and 3 percent respectively. During that period, capacity utilization in the manufacturing sector, as revealed by business surveys, fell by two percentage points in Germany and by three and a half percentage points in France. Meanwhile unemployment tripled to 3 percent in Germany and to 6 percent in France.

In the 1980s European growth has been even slower than in the devil's decade of the 1970s with its oil shocks and rapid inflation. Since 1980 inflation has dropped, profits have recovered, and real oil prices have declined, so it is difficult to believe that the potential growth of the European economies is now below 1970s trend rates. If the growth trends of the 1970s are extrapolated (and they are a conservative estimate of potential growth), GNP is now more than 5 percent below the trend line in Germany and more than 7 percent below in France. Unemployment in both economies has more than doubled since 1980 and shows little sign of decline. All these facts strongly suggest that, even if their maximum full-capacity (potential) growth over the very long run is only 2½ percent, these economies have enough slack to let them grow at 3½ percent a year for at least five years without any excessive pressure on resources. If they are to make any inroads on their serious unemployment problem, they need to do so.

In the first half of 1986 both economies grew at an annual rate below 2½ percent. Both the International Monetary Fund (IMF) and the OECD forecast that Germany's growth will accelerate to above 3 percent in the second half of 1986, but it is far from clear that a growth rate of 3½ percent will be reached, let alone sustained. Meanwhile, few forecasters expect the French economy to achieve even 3 percent

U.S. Policy and World Saving

Opponents of an expansionary fiscal policy in Japan and Europe often employ the argument that the world is short of saving. It is scandalous enough that the United States, the world's largest developed economy, should be soaking up the savings of others to finance its deficit, they say. What is the good of the United States putting its house in order if other rich countries start spending more relative to what they produce, reducing the available investment funds for developing countries? So goes the argument.

But that argument is seriously flawed. That the United States needs to reduce its budget and external deficits is not in dispute. On all past evidence, however, such a reduction would not be sufficient in itself to see a smooth redirection of world saving to other countries, and, in particular, to the developing countries. Furthermore, it is quite wrong to analyze the world economic situation as if output levels were immutable.

When the net demand for funds in the United States falls as the domestic saving/investment balance is restored, it is probable that the exchange value of the dollar rate will decline, reducing net imports. And as foreign countries face declining demand for their exports, their level of demand and output will be affected. World interest rates should decline, but lower rates will not be sufficient to maintain world output unchanged.

If countries like Japan and Germany want to maintain existing levels of output and saving but can no longer ex-

port saving at the same rate to the United States, they have, in principle, two choices. They can either invest more domestically to build up capital stock at home, or they can lend to countries other than the United States that can productively invest their savings to earn a higher rate of return.

Neither option is easy to achieve. In a market economy there is no foolproof way of raising the investment rate of the private sector. The most reliable way to raise domestic investment historically has been by judicious stimulation of demand, so raising levels of capacity utilization.

Nor is there any politically feasible scheme in sight to direct exports and credits on a larger scale to developing countries. The private sectors and particularly the banking sectors of industrial countries are currently very cautious about lending to debt-ridden developing countries despite the relative shortage of capital in those countries, which, in principle, implies that investment there should earn a high return. If the United States reduces its current account deficit but the developing countries are unable to increase their deficits because of their poor credit ratings, it follows that countries like Germany and Japan cannot continue to run such large current account surpluses. Domestic investment must replace exports if German and Japanese savings are to be kept up. And some sort of domestic expenditure must replace exports if the growth of output and employment is to be kept up.

growth in the immediate future.

The situation in Japan is similar. Trend growth there in the 1970s was over 4 percent a year. Unemployment increased, though remaining low by international standards, and reported capacity utilization rates fell. Led by export growth, the Japanese economy grew at above 5 percent a year in 1984 and 1985. Fueled by the U.S. expansion, Japanese exports rose at an annual rate of 17½ percent in 1984, and by nearly 6 percent in 1985. Domestic demand in Japan grew at less than 4 percent. Now as the export boom fades because of slow U.S. growth and a substantial appreciation of the yen, the Japanese economy has slowed too. GNP stagnated in the first quarter of 1986 and seems likely to have grown at less than 3 percent in the first half of this year. Even with the aid of falling oil prices, Japan, according to many forecasters, will not register a 4 percent annual growth rate in either 1986 or 1987 on current policies.

Fiscal Expansion Unfashionable Abroad

The case for expansionary policy in Europe and Japan can therefore be made purely in terms of their own situations. It is not necessary to invoke the benefits for exports and the debt-servicing capacity of developing countries nor the (marginal) contribution to U.S. adjustment that such a policy would yield. Yet the larger European countries and, to a

lesser extent, Japan are unwilling to consider any substantial changes of macroeconomic policy. Certainly concerted changes on the scale necessary to add a sustained 1 percent a year to the growth of their domestic demand, for example, are out of the question. Why?

Essentially, there are two reasons. First, a strong school of thought in these countries does not believe that any durable increase in activity can be achieved by macroeconomic policies, fiscal or monetary. American economists are schizophrenic on this issue. They teach that economies are stable and tend to return automatically to a "natural" unemployment rate that cannot be influenced by macroeconomic policies. Yet they are ready pragmatically to propose such policies to influence the level of demand when economies are clearly growing at below trend rates with substantial margins of spare capacity. Even so, such stimulatory policies are widely thought to have only a temporary effect. European policy-makers tend to believe the level of activity is supply-determined, and they fear that an expansionary fiscal or monetary policy would only temporarily boost economic activity but cause permanent increases in public-sector deficits or inflation.

The second reason, especially in Japan and Germany, is a deep-seated concern about public deficits. In the 1970s the budget deficits of those two countries grew considerably, largely because of the operation of the automatic sta-

bilizers, which tend to worsen the deficit as the economy slows down. The budget in each country went from a surplus in 1973 to a deficit of about 4 percent of GNP by the end of the decade. Yet, as we have seen, the automatic stabilizers did not prevent a decline in capacity utilization and a rise in unemployment.

The deficit problems in both countries were exacerbated by the second oil price rise and the policy responses of almost all industrialized countries. To combat inflation, industrialized countries followed the tight-money approach of the United States, driving real interest rates to record heights, which helped to precipitate a recession and throttle inflation. Consequently a lot of public debt was issued at historically high real interest rates, and the interest burden of public debt was greatly increased.

Germany and Japan undertook programs of budgetary retrenchment, reducing their deficits to around 1 percent of current GNP. Budgets, apart from interest payments, are back in surplus, and if GNP were at trend levels, the actual budget would again be in surplus because of the automatic stabilizers. Thus structural, or noncyclical, deficits have been eliminated in both Japan and Germany. A consequence of retrenchment has been a sluggish recovery from the 1982 recession, with much of what growth there has been coming from exports. Nonetheless both governments now prefer to sit it out; neither wants to risk a return to public-sector deficits with a fiscal expansion.

The position is held with greater vehemence in Germany where it is abetted by a general fear of inflation on the part of the electorate and a consequent tolerance of slow growth. In Japan the government itself recognizes a potential growth rate of 4 percent. Growth below that rate for any extended period would set up pressures for a change of fiscal policy.

Current policies in Germany and Japan are fortified by another consideration. In both countries, demographic trends foreshadow an aging of the population with predictable implications for pensions costs on the basis of current commitments. (In Japan the problem is compounded by the immaturity of the pension system.) If other elements of fiscal policy remain unchanged, public borrowing will have to rise just to cover social security obligations. As a result, the ratio of government debt to GNP could rise after 1990 and rise steeply after 1995. Consequently neither government is eager to incur any avoidable debt in the meantime.

Monetary Expansion?

European countries and Japan could seek to maintain or increase the tempo of economic activity by reducing short-term interest rates. If markets believed that short-term interest rates would be durably lower, long-term rates would fall too. Neither Germany nor Japan has any inflation to

speak of, and they are not growing fast relative to potential, so an easing of credit conditions could not plausibly be expected to lead to an outbreak of inflation. Interest rates have declined since 1984, but long-term interest rates are still around 5–6 percent in Germany and Japan. Even if inflation quickens to the range of 1–2 percent a year in those countries and is expected to stay there, real interest rates would still be above the trend growth rate and certainly above currently foreseeable growth rates. At current levels of unemployment, which cry out for an acceleration in growth, such high real interest rates are unjustifiable.

Of course the declared monetary strategy of the Japanese and many European governments is to focus not on interest rates but on monetary aggregates. That procedure is more stable in economies facing nonmonetary shocks. It loses some advantages, however, when the relationship among

money, prices, and economic activity is unstable or uncalibrated.

For example, the target ceiling on German monetary growth of 5½ percent a year seems adequate to accommodate 2 percent inflation and 3½ percent real growth, until it is recalled that the income velocity of the targeted aggregate (Central Bank Money) has been falling in Germany for years.³ The rate of decline in velocity since 1973 has been about 1½ percent a year. If that trend goes on, the top of the German target range for monetary growth “leaves room” for nominal income growth of only 4 percent a year. If reducing interest rates led to some overshooting, therefore, there need be little cause for concern. In particular, the Bundesbank’s reputation for being concerned about inflation seems likely to survive the experience.

Lower interest rates and faster money growth could well happen if growth continues to be slow. There may be some reluctance to reduce interest rates because the size of the boost to world growth from lower oil prices is an unknown and controversial matter. It is possible that growth will be quicker in 1987 than many now predict. Some governments would prefer to wait until next year to see how things go and then ease monetary policy if need be.

The Need to Cooperate

Secretary Baker has told the Japanese and Europeans that the only way the United States trade deficit can be slashed is if the dollar depreciates further or their economies grow faster. Yet they are reluctant to take decisive action to stimulate domestic demand growth. And even if they did, the effect on the U.S. trade deficit would probably be only marginal. Through monetary policy, the Federal Reserve has considerable influence over both U.S. economic activity and the dollar’s exchange rate. That being so, the administration may be tempted to abandon seeking cooperation from other countries and concentrate on having its way with the Federal Reserve. That would be a grave error. The current

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world economic situation carries two opposite dangers. The world is traveling a road with a deep ditch on either side; the risk of falling in one or the other is much greater if monetary policies are not coordinated internationally.

The first danger is that there may be a recession if policy-makers in different countries cannot predict each other's actions and all err on the side of caution. A faster U.S. monetary expansion, if other countries do not ease their monetary policies, could cause the dollar to plummet too far too quickly. That risk may inhibit the Federal Reserve from acting vigorously enough to stave off recession in the United States. So far, that sequence of events has not occurred, but the real test may lie ahead — in 1988, if Congress follows a policy of progressive deficit reduction, as it should. If the Fed is inhibited and at the same time foreign governments retain their reluctance to stimulate their own demand growth, the world could slip into recession.

The converse danger is an inflation caused because countries do not take account of each other's policies. A set of policies, each of which makes sense in isolation, can add up to collective error. The United States could permit a rapid expansion of credit to avoid a prospective recession, while other countries respond vigorously with monetary expansion to avoid an appreciation of their currencies. These actions could lead to renewed worldwide inflation — the mirror image of the early 1980s when a general but uncoordinated monetary contraction led to a deeper recession than anyone expected. There is some evidence that world slumps and inflations over the past 20 years have been linked with variations in the U.S. money supply coupled with parallel movements in foreign monetary aggre-

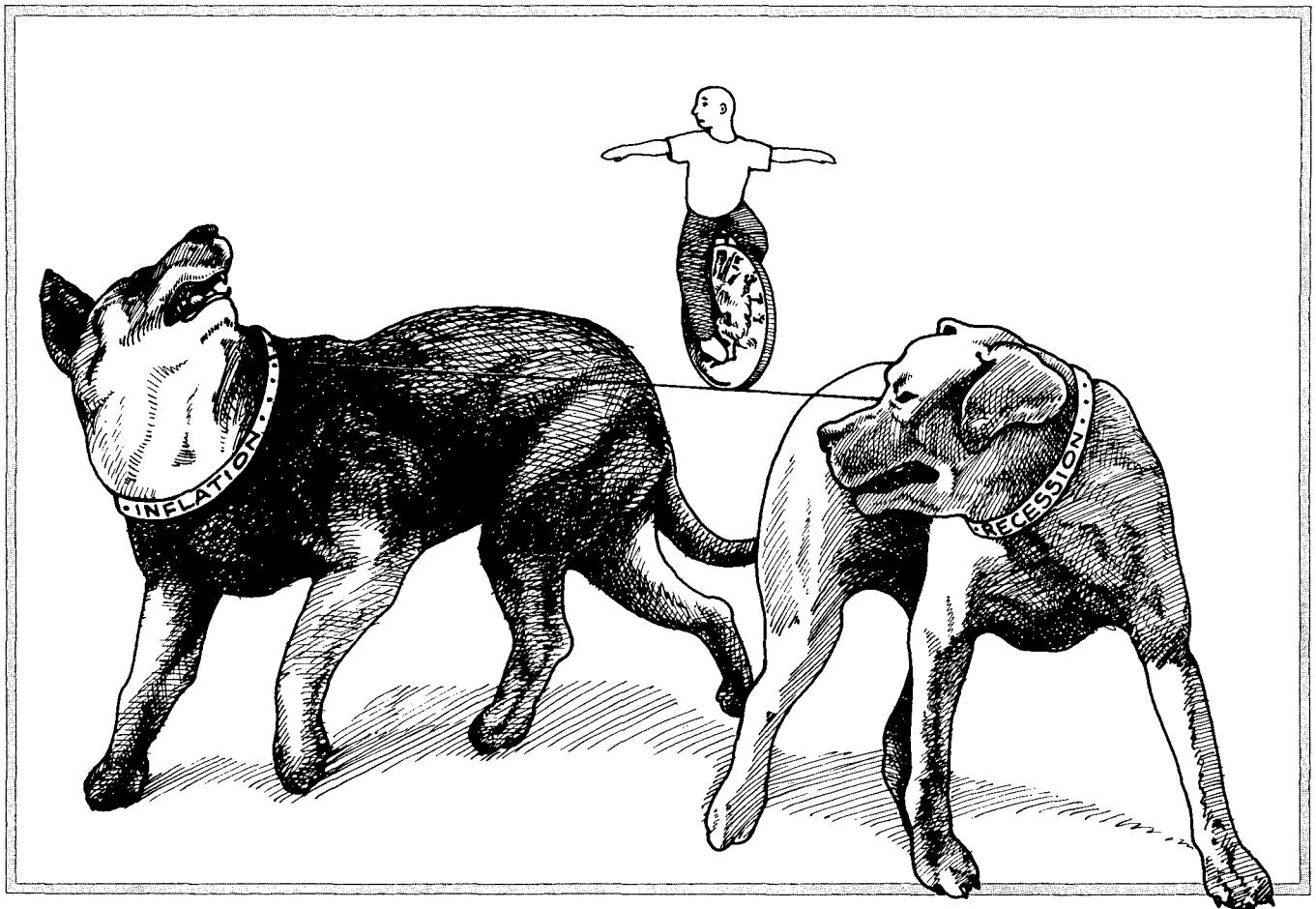
Conference on Econometric Models

The Brookings conference, held on March 10–11, 1986, entitled "Empirical Macroeconomics for Interdependent Economies: Where Do We Stand?" had two objectives. One was to evaluate the current state of the art of empirical modeling of economic interactions among the larger industrial economies. A second was to explore the implications of the current policy mix in the United States on the dollar and on foreign economies and the feedback effects on the United States of policy actions abroad.

Twelve prominent multicountry econometric model teams took part in a preliminary workshop and prepared a set of simulations based on common assumptions. Models from national government agencies, international (inter-governmental) organizations, commercial consulting and forecasting firms, and academic institutions were all represented.

The exercise was part of a Brookings research program on macroeconomic interactions and policy design for interdependent economies, financed by grants from the National Science Foundation and the Ford Foundation. The proceedings of the conference are expected to be published next year.

This article makes use of the author's interpretation of the results generated by the participating models. The modeling groups cannot be held responsible for this interpretation of the conference results.



gates as countries resisted exchange-rate changes. It is essential, therefore, that monetary policy be internationally coordinated in the years ahead.

The overall stance of monetary policy in the OECD as a whole should be appropriate in the light of current forecasts of real growth and inflation in the world economy. At the same time, relative monetary policy settings should not make it difficult for exchange rates to settle at levels consistent with equilibrium in external current accounts. For example, a relative tightening of U.S. fiscal policy, compared to that of other countries, in the years ahead should tend to bring about some further decline of the dollar, leading to a more sustainable pattern of world current balances. Relative monetary policy settings should not impede that dollar depreciation.

What do these risks mean for the conduct of international economic discussions in the immediate future? First, there seems little payoff in getting into official arguments about fiscal policy. Second, because the immediate growth outlook is uncertain and there is some possibility that OECD growth could accelerate out of current sluggishness, it is more important at this stage to work out the principles of international monetary coordination than to argue about the timing of coordinated monetary moves.

Economic policy should be made on the basis of the best available forecast of where the economy is going rather than on the basis of where it has just been. Securing agreements based on forecasts at a given time, however, can be difficult because forecasts can be manipulated or disputed in a way

that facts cannot. And policy-makers usually have their hands more than full dealing with the present; they have a rooted aversion to considering anything that might not happen. Nonetheless, a potentially fruitful approach would be to seek conditional agreement for coordinated monetary measures. It would be better to agree now on the correct response if nominal world GNP growth during the remainder of 1986 shows no — or only weak — signs of accelerating, rather than waiting for fears to be confirmed before beginning discussion. Conditional agreement — committing the parties to do something if stipulated events occur and if agreed indicators fall within specified ranges — may be the only way to secure timely coordinated policy responses and to minimize the danger of either recession or inflation.

1. The simulations assumed that monetary policy was set to maintain the same growth of the money stock as would have occurred without the fiscal contraction.

2. There was some diversity among the models, but the disparities were not enormous in this particular case. The standard deviation for the results in the third year was just under four-tenths of a percent. That statistic might be interpreted to mean that while the average estimated effect on GNP in the third year was about 1 percent, there was 60 percent likelihood that the effect would fall in a range between six-tenths of a percent and 1½ percent.

3. Income velocity is defined as the ratio of nominal income (GNP) to the money stock. If the money stock typically grows faster than nominal income, velocity falls.

Deficits, Debt, and the World Economy

*A Conversation Between Robert V. Roosa
and Bruce K. MacLaury*

AT THE REVIEW'S invitation, Robert V. Roosa, who recently stepped down after nearly 12 years as chairman of Brookings' board of trustees, met with Brookings President Bruce K. MacLaury to discuss international economic problems. Among the issues they addressed were the declining dollar, the U.S. trade and budget deficits, and the continuing debt crisis in the developing countries.

Roosa has been an active participant in national and international monetary affairs throughout a distinguished career. Since 1965 he has been a partner in the private banking firm of Brown Brothers Harriman and Company. He has just completed 10 years as chairman of the New York Stock Exchange Advisory Committee on International Capital Markets and continues in his 15th year as a member of the Advisory Committee of the

International Finance Corporation. He joined the New York Federal Reserve Bank in 1946 and was named vice president in 1956. From 1961 to 1964 he served as under secretary of the Treasury for monetary affairs.

From 1971 until 1977, when he was named president of Brookings, MacLaury was the president of the Minneapolis Federal Reserve Bank. He served as deputy under secretary of the Treasury for monetary affairs from 1969 to 1971, with special responsibilities in the areas of debt management and international financial markets.

Prior to 1969, MacLaury served with the New York Federal Reserve Bank, the U.S. Treasury, and the Organization for Economic Cooperation and Development. The conversation between MacLaury and Roosa took place in late July.



Robert V. Roosa and Bruce K. MacLaury

MacLaury: Bob, let me start out, if I may, with the subject of the dollar and the exchange markets. U.S. business and government officials have been worried for a long time about the overvaluation of the dollar. Within the past year we've seen a fairly substantial drop in the value of the dollar, particularly against the yen, but also against the deutsche mark and some other European currencies. Do you think that the dollar has declined about as far as it is likely to go, and is it necessary to go further to make U.S. exports competitive again?

Roosa: I think that the change has gone far enough for the time being in the case of the yen. The other currencies probably have to rise a little more against the dollar to catch up with the yen and restore the balance that prevailed in the late 1970s.

I think it is a mistake to believe that you can eliminate the Japanese and German trade surpluses entirely through exchange-rate adjustments. My own feeling is that while exchange-rate change is a necessary condition for restoring balance in the trade relations among these large countries and the rest of the world, it is not a sufficient condition.

MacLaury: If exchange-rate adjustments are not sufficient, what other kinds of policies are needed and who should initiate them?

Roosa: We can look at the exchange rate as providing an umbrella under which other actions can be taken. For example, currency misalignments provided the initial stimulus for the concept — growing out of the succession of economic summits over the last 10 years — that the major countries have a responsibility to move toward a convergence in their economic relations.

Now, without necessarily moving to precise targeting of exchange rates — although that may eventually evolve — the concern over exchange rates makes it possible to bring the economic policies of key countries closer together. I would propose, as a first step, that systematic efforts toward convergence be limited to the five countries whose currencies form the basis for the valuation of Special Drawing Rights (SDR), the central currency of the IMF: While Italy and Canada, the other members of the economic summit process, have significant peripheral relationships, the first emphasis ought to be on the United States, Germany, Japan, the United Kingdom, and France.

Indeed, I presume that representatives of those countries are already beginning to meet in accordance with the terms of the recent Tokyo summit communiqué. As you know, for the first time, the heads of state went beyond pleasant euphemisms asking for convergence to request that their finance ministers report regularly on the development of objective criteria for gauging the ways in which their various economies are interacting, whether those economies are moving either toward equilibrium or away from it.

For each country, the finance ministers will have to consider an array of information, ranging from what is happening to price levels, interest rates, and capital flows to assessing the internal performance of each economy, whether it is in balance or in unsustainable growth or recession. These facts and trends deserve the sustained attention not just of the deputies, meeting to sort out the data and to identify key policy questions, but also of the finance ministers and central bank governors who can negotiate among themselves as to what priority actions should be taken and then refer recommendations to their heads of state.

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MacLaury: Bob, don't we have a problem though? Coming out of the Tokyo summit, the United States made a new commitment to participate in a surveillance process to help bring convergence in economic policies. Yet right now, many people, myself included, think that with the slowing of the U.S. economy and the decline in the dollar, foreign economies, particularly Japan and Germany, are also in danger of slowing. It doesn't take a very sophisticated surveillance process to conclude that Japan and Germany need to take more expansionary domestic measures. Yet I see few signs that those countries are prepared to take such measures. Do you really think that target zones or some formalized system of surveillance is going to inspire more political will than we have right now?

Roosa: We won't get to Nirvana on the first move. But we have to make a start. I don't think it is appropriate at this stage to try to identify target zones for the exchange rates of the key countries, even though I've been recommending for the past 14 years that we begin to move toward such a system. But I do think we have to recognize the interrelationships and begin dealing with divergent tendencies among them. Convergence, in principle, is a very important step beyond the organizations such as the OECD and the IMF Group of 10 that some of us were instrumental in establishing back in the early 1960s to explore and expose differences in economic performance among the major countries that have disruptive balance of payments consequences.

These earlier information exchanges were very important building blocks. Now a new building block — negotiation in the context of economic summits — can be set upon that foundation of information exchange. And eventually I think we will see some semblance of the impact on domestic economic policies that in the old days used to be identified with the discipline of the gold standard. Countries will again come to recognize that outside pressures will compel them to readjust major government influences on income

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distribution and on production as these impact on exports and imports. Under the gold standard, countries recognized that they had to be responsive to the signals that were coming across the foreign exchanges. We now have an opportunity to put in place a negotiating process through which some of those same effects can be achieved. But we have to work at it without assuming that we are going to get all the answers the first time around.

MacLaury: Can I come back for a moment to the value of the dollar? As you know, Paul Volcker has expressed concern that the dollar may fall too far too fast. In particular he was worried that lowering U.S. interest rates unilaterally could cause the dollar to drop suddenly rather than move down in a gradual way. Do you think that concern was justified?

Roosa: I think it was in past months. But now I don't think the possibility of a further free fall is as likely as in the earlier stages of the correction. Volcker's concern was that too rapid a fall in the dollar would lead to such an abrupt adjustment in exports, imports, and capital flows among the key countries that the adjustment itself would create a severe disruption within these economies. Instead a continuing but steady change in exchange rates would permit more orderly adjustments within each country, and that is closer to the pattern that has evolved over the past year.

We can see the pressures resulting from the exchange-rate changes that have already taken place. I have just spent a week in Japan in discussions with Japanese economists, as well as some American businessmen. It became evident that Japan recognizes the need for structural change within its own economy. And the Japanese are already seriously at work on what those changes can be — reflected, for exam-

ple, in the recently published report of a committee chaired by the former governor of the Bank of Japan, Haruo Maekawa. The United States, for its part in the adjustment, has also recognized that we have a job to do in reducing our federal budget deficit, but we are logjammed in Congress.

The Japanese have just reelected a government that has already made commitments for structural change. They are investigating, for example, whether they can stimulate the domestic economy by encouraging housing construction and, in that way, use somewhat more of their savings at home. And they are looking for other ways to reduce their dependence on exports to sustain growth, and instead to make Japan a more significant importer from the rest of the world, particularly from the developing countries. Another report, from a committee chaired by former Foreign Minister Saburo Okita, calls for Japan to deliberately shift the capital flows generated by its export surpluses to the developing countries.

MacLaury: You mentioned that you felt that the yen/dollar exchange rate may have moved far enough for the time being. But we've seen very little change so far in the U.S. trade deficit. Obviously, U.S. trade reflects transactions with countries other than Japan — Canada and Latin America in particular and other parts of the world where currencies have not adjusted at all. But have you been surprised that our trade deficit has been so unresponsive to the movements in the exchange rate that have already taken place?

Roosa: Well, as economists, we know that in any change of this sort, a so-called J curve functions. This means that even after the dollar declines, the trade deficit, for a time, becomes larger. No one is altogether clear on how long it should take before a reversal begins. In the present case, I think there are other factors delaying a correction. For example, other leading countries are not growing fast enough to take up exports from the United States and thereby moderate their very large trade surpluses. Moreover, during the protracted period of the strong dollar, other countries established a strong foothold in the United States and did so well in terms of earnings that they now have room to squeeze profit margins in order to hold their position in this market — thereby keeping our imports for some time at the high levels reached when the dollar was so very strong.

Nevertheless, while the dollar value of Japanese sales in the United States hasn't changed, declining physical volumes are beginning to show the first evidence that we may be on the upside of the J curve. Furthermore, in companies with which I'm associated, I see evidence that U. S. exports are picking up, though not yet on a sufficient scale to make a major dent in the data.

MacLaury: While we are waiting for this benefit from previous exchange-rate adjustments, we are still major importers of foreign capital. As a result, within the space of a very few years, the United States has transformed itself from the world's largest creditor into a very large debtor. Those debts are going to have to be serviced and/or paid back. Is this something that U.S. policy-makers ought to be concerned about?

Roosa: It is indeed an additional concern. In the past, even when our exports were not robust, our net earnings on overseas investments were a source of strength for our overall balance of payments. That safety margin is now gone. In any case, the United States ought to be providing exportable capital, which the rest of the vast developing world

will always need. We may not get there within the next decade, but the Japanese and German surpluses, though they will be declining as our deficits shrink, can and should fill the kinds of needs that the world has had for generations for some capital to flow from the advanced to the developing countries.

Growing Out of Debt

MacLaury: That leads directly to the issue of third world debt. The United States was a major exporter of capital to the developing world in the late 1970s and early 1980s, but that came to a halt four years ago. Since then there have been a number of efforts to deal with the overhang of developing country debt. Last fall Treasury Secretary Baker proposed a plan to help the developing countries grow out of their deficits rather than make increasingly stringent efforts to cut back. It has been nearly a year now since that proposal was put forward. Do you see any progress?

Roosa: Well, progress is certainly scattered and remote. But the most significant part of the process up to now is that the United States has spoken out in favor of developing the capacity for growth in other countries through encouragement of private enterprise and reliance on the market processes to determine prices and allocate resources. I think this is in the interest of the developing countries.

It has also been extremely important that Baker gave fresh initiative to the need for the IMF and the World Bank to pool their capabilities to deal with a pair of inseparable problems in debtor developing countries; that is, getting the country to exercise enough restraint to permit shorter-term financing of external deficits while, at the same time, introducing a program of sufficient restructuring in its whole economy to encourage investment from outside. What I like about the Baker initiative is the fact that at least we now have in motion efforts to pool public and private resources without sacrificing the separate responsibilities of the Fund and Bank. Instead of depending solely on austerity to grind down demand — while maintaining sufficient constraint to minimize further dissipation of resources — the Baker plan encourages major new efforts to promote growth within a context of reliance on market mechanisms and private ownership.

This approach also means inviting foreign private capital. There has been very little publicity yet about a creative new program called GRIP, developed by a subsidiary of the World Bank, the International Finance Corporation. GRIP stands for Guaranteed Repayment of Investment Principal. Without going into details, let me simply say that it sets out means for dealing with two of the key problems of developing countries.

First, it provides reassurance to outside investors who may see new opportunities through participating in the restructuring programs that are under way. Second, since all of these countries are heavily indebted to banks, it provides an opportunity for the banks to convert their loans into equity in the borrowing companies. With the approval of the IFC, the equity would become "gripped," and the bank would then be in a position to sell the equity. This may mean, of course, some revision by the bank of the book value of the asset, but it also removes the burden of nonperforming loans.

And from the debtor's point of view, since he's not ex-

pected to pay dividends until he earns a profit, he doesn't have an interest burden to meet. I think this kind of creative approach can be helpful, especially in contrast with other suggestions that look much more like outright charity or subsidy. Outright debt forgiveness undermines efforts to attract new funds for developing internal growth potentials; market participants in these countries must understand the need to maintain creditworthiness and must not be dependent upon having the size of their debt cut in half or all the interest forgiven.

MacLaury: But, as you know, Bob, Senator Bill Bradley has recently proposed a less extreme form of debt forgiveness. It would reduce the level of interest payments and forgive 3 percent per year of principal for selected countries. Bradley argues that the Baker plan would add to the debts of countries that are already incapable of repaying them, and that it is unrealistic to expect them to pay even more.

Roosa: I understand the concern. All I'm indicating here, however, is that to the extent that new capital inflows or debt renegotiation can take the form of equity, the whole relationship is a different one. In terms of dealing with the debt that already exists, I believe it may be helpful to postpone repayments. But the idea of having wholesale markdowns is simply difficult to carry through without applying it across the board to every country.

MacLaury: Isn't it important that the domestic savings of these developing countries that have been sent abroad to safe havens be repatriated? Isn't that at least as important as bringing in new funds?

Roosa: Indeed it is. Mexico's present debt exposure is equivalent to the amount of its own capital that was invested outside the country during a succession of crises that began



"Isn't it important that the domestic savings of these developing

countries that have been sent abroad to safe havens be repatriated?"

in 1982. Mexico has already begun to attract and hold capital through special debt issues to its own nationals. And along with that, I hope there will be a greater readiness to welcome investment from outside.

MacLaury: Apart from the question of developing country debt, do you feel that the risks of a financial crisis have increased as a result of financial market innovations, such as off-balance-sheet financing, options trading, securitization, interest rate swaps, and the like?

Roosa: I think there is increased riskiness. Moreover, there is a possibility that these increased risks further reduce the already modest commitments that major banks are prepared to make to help the developing countries. Some of the banks have become almost flamboyant in their readiness to adopt new techniques and to balloon off-balance-sheet commitments in ways that are difficult for the regulators themselves to understand and oversee. As you know, the first effort to study the impact of these innovations has just been completed under the auspices of the Bank for International Settlements.

The role of the regulator should not be to stifle initiative but to prevent excesses that could lead to a crisis. I think that task is being addressed, but I can't say that I feel assured that the regulators yet have an adequate grip on these innovations. And they will be opposed by those who, in the name of free enterprise and creative private initiative, will say that the regulators are just obstructionists who don't understand how the system really ought to grow.

Domestic Deficit

MacLaury: Let me come back to a question concerning the domestic federal budget deficit. Many people believe that we are going to find it difficult, if not impossible, to get improvements in our trade account unless and until we manage to get our own budget deficit down. At this stage, do you feel that we are making enough progress on tax reform and the federal deficit?

Roosa: There is no doubt that the federal deficit must get on a credible downward path and that reducing the balance of payments deficit is one of the compelling reasons for reducing the domestic deficit. We're not making satisfactory progress yet in my view. Indeed, we are facing a paradox. The president espouses private enterprise with great per-

suasiveness. Yet the tax committees of Congress are negotiating tax cuts for individuals that are going to be financed by additional taxes on the corporations that are supposed to promote growth in the economy.

Moreover, it is my own view that for at least the last three or four months, it has been the uncertainty about the final version of the tax bill that has put a paralyzing hand on the whole decision-making process in the business community. I know of dozens of firms that are carrying on a minimum of maintenance investment but postponing major creative and expansion programs because no one can calculate what the after-tax return on the investment will be. This uncertainty has cast a pall over the economy that is itself responsible for holding the economy well below its potential.

The sooner the tax bill is finalized, the better — even though some of the decisions might not be to my liking. Otherwise, I can see the economy drifting down through the remainder of this year until enough confidence is lost that we can no longer attract capital from around the world. Substantial withdrawals of foreign funds would make the financing of our budget deficit even more difficult, raise interest rates, and result in additional economic distress.

MacLaury: We've been talking about the uncertainties associated with tax reform. There's a different kind of uncertainty associated with the budget deficit itself. Many people, myself included, thought that the economy was sufficiently robust that it could stand the fiscal restraint of reduced budget deficits, particularly if monetary policy were eased. Now, with signs of a weaker economy, I am concerned about whether Congress should try to meet the Gramm-Rudman deficit reduction targets.

Roosa: That is a difficult question at the moment. Moreover, the answer is not simply to say, let's have easier money. I think we've had an accommodative monetary policy all along, to the extent that money can provide the liquidity that any functioning economy needs. If anything, we're close to an excess of liquidity right now and might find ourselves in that classic position of pushing on a string if we tried to do much more with monetary policy at this stage.

Any reduction of the domestic budget deficit — particularly if it's on a large scale — will constrict the economy. Nonetheless we need to get the deficit down. We need to lower our dependence on external capital and find a way to shrink our own balance of payments deficit. But this involves a combination of domestic measures that is much more intricate than simply easing money to offset higher taxes.

We have had great difficulty in getting control over the nondefense segments of the budget. And we have to find ways of gradually, but determinedly, trimming the growth in defense expenditures as well. Based on my own interpretation of data and analyses in Brookings' remarkable series of studies on the defense establishment, I believe this country can maintain an adequate and strong defense capability while cutting back the defense budget from a quarter to perhaps a fifth of the total national budget. The question remains whether we can gain anything useful through more effective negotiations with the Russians on matters of arms control. In the end, preserving confidence in the American economy involves issues that go well beyond questions of balance between monetary and fiscal policies, important as that balance may be.

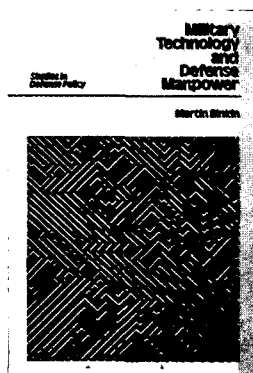
*"There is no doubt
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Smart Weapons Need Smart Soldiers

Military Technology and Defense Manpower

By Martin Binkin

\$8.95 paper; \$22.95 cloth.



WEAPONS TECHNOLOGY has outstripped the capabilities of military personnel, Brookings senior fellow Martin Binkin argues in a new study. "Given present trends in arms technology and demographics, by the early 1990s the nation's armed forces could be caught between a growing requirement for skilled people to operate and maintain sophisticated weaponry and a diminishing supply of youthful recruits capable of absorbing complex training," Binkin writes in *Military Technology and Defense Manpower*. Training programs must be upgraded and weapons made more "user-friendly" if the nation is to realize a full return on its substantial investment in military hardware, he says.

Over the next decade, the U.S. military will exploit advances in a variety of technologies. The microelectronics revolution is expected to have the most pervasive effect, leading to a total integration of aircraft avionics; fostering a transition from "smart" to "brilliant" weapons; and ushering in a golden age of command, control, and communications. "Even allowing for exaggerations inherent in projections of breakthroughs, by the mid-1990s the concept of the electronic battlefield — on land, sea, and in the air — could well move from the realm of science fiction several steps closer to reality," Binkin writes.

High-tech proponents argue that advanced weapons not only give a critical performance edge to U.S. armed forces but also can reduce the number and qualifications of people required to operate and maintain them. Such promises must be viewed with skepticism, Binkin contends. History indicates that while technological advances have produced more capable military systems, their complexity has made many of them unreliable and hard to maintain.

Built-in diagnostic equipment, for example, has turned out to be as complicated to operate and maintain as the prime-mission equipment it is meant to monitor. It often fails to detect problems or identifies failures where none exist. Early experience with the diagnostic equipment in the Air Force's F-16 avionic system indicated that only about half of the actual malfunctions were being detected and that 45 percent of the faults detected were false alarms. Such low fault-detection and high false-alarm rates have added to the maintenance workload, necessitating additional and more highly skilled personnel.

Binkin also takes issue with the premise that newer systems incorporating advanced technology are easier to operate than their predecessors. A case in point, he says, is the Stinger, a shoulder-fired, heat-seeking missile considered the top-of-the-line "smart" weapon against low-altitude aircraft. To operate the Stinger successfully a soldier must make split-second decisions involving a combination of motor and cognitive skills through each phase of an 18-step engagement process. Army researchers concluded in 1983 that the Stinger was extremely sensitive to the skill of its operator and too complicated for the caliber of soldier assigned to that duty. This smart weapon, it turns out, requires an equally smart operator.

The weight of evidence is that both new and replacement weapon systems will demand ever more skillful personnel, especially if the new systems' capabilities are to be fully exploited. In contrast to the end of World War II, when 13 percent of enlisted personnel were assigned to technical jobs, today almost 30

percent are technicians. "Prudent planners should anticipate that the services' requirements for bright, technologically literate individuals are unlikely to diminish in the years ahead," Binkin writes. "It is more likely, given the present course, that the need for such people will grow commensurate with the complexity of the systems being fielded."

Binkin suggests that providing formal training early in the first enlistment period must be challenged on both cost and effectiveness grounds, because low reenlistment rates lower the investment of this early training. Furthermore, the same technology that increases the need for more and better manpower should be used to provide innovative ways to train personnel, he says. The military should exploit recent developments in microprocessor-based instructional systems and use advances in simulation technology to conduct realistic training with greater efficiency.

Most worthy of attention, the author writes, are options that diminish the need for large numbers of highly qualified technicians by reducing the complexity of military systems, by making them more reliable, and by facilitating their maintenance. While these measures have not received their full due in the past, largely because of the military's preoccupation with fielding high-performance systems as early as possible, the cost of continued neglect will grow as the gap between weapons and skills widens.

The armed forces can avoid being squeezed between growing demands for a technologically adept work force and a shrinking supply of qualified prospects, Binkin concludes. "Affording manpower equal billing with performance, schedule, and cost early in the weapon development cycle would brighten the prospects that the systems fielded by the armed forces in the future will be within the capabilities of their personnel and that the nation will realize a fuller return on its investment in military technology."

Transportation Policy and the Disabled

THE MAKING of transportation policy for the disabled has been marked by vaguely worded statutes, confusion in the legislative process, uncertainty in the administrative process, and not always consistent judgments in the courts, according to a new Brookings study. The story reveals flaws in policy-making that have led many people to believe that government is not working as it should.

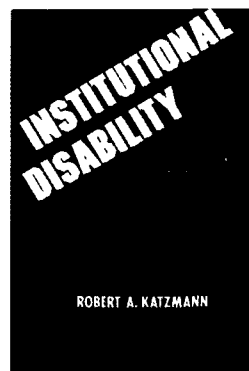
In *Institutional Disability: The Saga of Transportation Policy for the Disabled*, Robert A. Katzmann, a lawyer and political scientist, finds that the confusion resulted from the government's failure to define the problem precisely and to choose between two conflicting approaches — one oriented toward the right of equal access for the disabled and the other favoring effective mobility by any practical means.

The debate began in 1970 when Congress first decreed that "special efforts" be made to ensure that the elderly and the disabled could use mass transit. The provision passed with virtually no discussion and became the basis of the effective mobility concept. The linchpin of the equal access approach was Section 504 of the Rehabilitation Act of 1973, a one-sentence prohibition against discrimination toward the handicapped. This provision had no legislative history, Katzmann writes, was passed without hearing or debate, and was buried in a largely unrelated piece of legislation.

Policy seesawed between the two approaches for the next 12 years, reflecting the basic clash of values between equity and efficiency. Those conflicts, Katzmann says, were compounded by the increasing fragmentation within and among national institutions, including a legislature with often undisciplined processes, an executive branch with competing bureaucracies, and a judiciary with conflicting views of legislative intent. Katzmann, a senior fellow in the

Institutional Disability: The Saga of Transportation Policy for the Disabled

By Robert A. Katzmann
\$10.95 paper; \$28.95 cloth.



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Brookings Governmental Studies program when he wrote the book, examines in detail the shortcomings in each of the three institutional realms.

The effect of the flip-flops in policy-making was prolonged uncertainty and some loss of the government's credibility, plus the absence of a policy that firmly addressed the transit needs of disabled people. So long as the federal thrust was likely to keep changing, local governments had little incentive to devote their energies to devising programs to satisfy soon-to-be-outdated requirements. The absence of clarity also impeded technological development because the transit industry could not determine with reasonable certainty whether policy would remain the same or change course.

Given the clash of basic values and the pluralistic governing system, it perhaps would have been too much to expect that transportation policy-making would be smooth or tidy, Katzmann writes. Americans want a system that is flexible enough to allow change. "Over time, we expect institutions to help make sense of complexity and confusion, to clarify choices and resolve differences," he says. "But in this case, at least, institutions were often not up to the tasks before them."

The problem now seems to have been resolved, at least at the federal level. In May 1986, the Reagan administration issued regulations giving considerable leeway to local governments to decide how best to meet the transportation needs of the disabled community. As those local bodies proceed, Katzmann says, they should keep in mind that what is needed is a policy that firmly sets its goals, not simply a grab bag of programs resulting from political accidents and backdoor approaches. "Government efforts," he concludes, "need not and should not be based upon the haphazard passage of legislation, on measures that pass unobserved, on ever shifting policy directions. It is incumbent upon institutions to respond in a more coherent way to citizens with disabilities, to those who seek access to society so they can contribute to it to the fullest extent possible."

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